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THE HOUSE THAT PUTIN BUILT

by

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The purpose of this thesis is to explore in what direction President Putin is attempting to drive the Russian economy. Now that Russia is past its initial transition phase, this thesis addresses the question of whether or not Russia has the necessary elements in place to ensure its success as a market economy. In order to answer this question this thesis considers the roots of economic change within Russia, starting with the Gorbachev era. The rule of law is also explored and how it affects the stability of the Russian market. The Yukos case is used to serve as a marker for the establishment of the rule of law as it transcends all eras starting with Gorbachev and culminating under Putin. The main argument is that President Putin inherited a state rife with corruption and controlled by a select few who would steer the economy in order to further their own self-interest. Even though Putin was constrained by the legacy of the past, he has taken actions to counter corruption and keep Russia on the path of economic reform through 'managed capitalism.' However, he has fallen short of building the institutions necessary to create a transparent market economy.

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THE HOUSE THAT PUTIN BUILT

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I. INTRODUCTION

The purpose of this thesis is to explore in what direction President Putin is attempting to drive the Russian economy. Now that Russia is past its initial transition phase, this thesis addresses the question of whether or not Russia has the necessary elements in place in order to ensure its success as a market economy. In order to answer this question I consider the roots of economic change within Russia, starting with the Gorbachev era. The rule of law is also explored and how it affects the stability of the Russian market. The Gorbachev era is an essential starting point in order to effectively map out the types of economic systems and which of their elements were passed from Gorbachev to Yeltsin and finally to Putin. By mapping out each system, the reader should gain a greater understanding for exactly what Putin has had to work with and whether or not he is dedicated to further developing a market economy within Russia, as well as the role that the rule of law plays in transitions to a market economy. I argue that President Putin inherited a state rife with corruption and controlled by a select few who would steer the economy in order to further their own self-interest. Considering the hand he was dealt, he had the difficult task of overcoming Russia's volatile political and economic climate present at the beginning of the century. I also argue that in order for Putin to develop a transparent market economy and ensuring Russia's place in the World Trade Organization (WTO), he must develop viable economic institutions and a state that is committed to the rule of law.

A. STRUCTURE

The first chapter of this thesis will examine the Gorbachev era. The specific questions that will be looked at are: what type of system did Gorbachev inherit from the Soviets? How did this system affect the types of decisions he made with regards to shaping the Soviet economy? And how did these decisions lay the ground work for the Russian economic transition? The second chapter will then examine the transition that occurred under Yeltsin. The questions that will be addressed are: what did Yeltsin do with the system that he inherited from Gorbachev? What methods were implemented to privatize the Russian economy? To what extent did 'shock therapy' pave the way for corruption to infiltrate all aspects of the Russian political system? And how did this system allow for the birth of a new elite class of businessmen and politicians called the oligarchs? The third chapter will focus on Putin's presidency during the years 2000 through December, 2004. It will answer the questions of: what types of systems were in place when Putin became president? Is Putin attempting to establish a transparent free-market economy that abides by the rule of law or is he attempting to control the market through political means? What steps did Putin take to clean up the corrupt economic system? What are the effects of his decisions? Given the constraints what type of economy is Putin capable of creating? Should we expect more?

In order to better illustrate the central elements of the Soviet and Russian economic systems, I will use the rise and fall of Mikhail Khodorkovsky and Yukos to exemplify the arguments made throughout the thesis. The reason for using the Khodorkovsky case is that it transcends all eras and culminates under Putin's regime. During the Gorbachev era, Khodorkovsky was a product of the Soviet system who demonstrated a deep understanding of the intricacies of the system and how that system could be manipulated in order to further his own interests. Under Yeltsin, Khodorkovsky's shrewd way of handling business ventures allowed him to become one of the richest men in Russia. Once Putin came into office, Khodorkovsky was well on his way to becoming Russia's wealthiest man as his oil company Yukos produced two percent of the world's total oil production. Khodorkovsky continued to show his flexibility as he came to see the value of making Yukos more transparent to western investors. In 2001, Yukos was one of the first companies to pay dividends on its stocks and at its height was valued at over thirty billion dollars.[1] Khodorkovsky and Yukos appeared to be the model for other Russian companies to follow.

However in 2003, Yukos became the target of the state as the oil company was investigated for tax evasion. In October 2003, Khodorkovsky was arrested and charged for fraud and tax evasion. His arrest would raise questions surrounding the true reason

[1] "YUKOS announces new dividend policy and interim dividend of USD 100 million," Press Release Moscow, October 26, 2000, http://www.yukos.com/new_ir/Press_releases.asp, accessed March 2005.

behind Khodorkovsky's arrest. Some of these questions centered on whether or not this was an isolated incident or if Yukos marked the start of further investigations into other industries that were privatized during the 1990s. Others questioned the state's motives and its implications with regards to foreign direct investment (FDI). The Yukos case will be used as an example for examining the steps that Putin has taken towards building the Russian economy and the consequences of those actions.

The primary sources of information used are the work of academics and their analysis of the Russian economy. Other sources include analysis by economists, financial analysts, scholarly journals, and the international press.

B. BACKGROUND

Since taking the reins four years ago, Putin has shifted the direction of the economy since its development under Yeltsin. When Putin became president he was faced with several challenges. The Russian economy was dominated by an elite class that worked primarily to further their own self interests. The economy was also rife with corruption from the top down, the rule of law was almost completely absent, and the institutions that were necessary to ensure a viable market economy were exceedingly weak or absent. Putin had the daunting task of creating the market institutions that would allow Russia to transition to a transparent market economy. He was also faced with getting a handle on Russia's rampant corruption. At first it seemed that Putin was creating a 'managed democracy,' however, it now appears that he is actually creating a system for 'managed capitalism.' Putin's actions in the strategic placement of those loyal to him in positions of power within the energy sector and his pursuit of Khodorkovsky and Yukos serve as examples of how far Putin was willing to go in order to regain control of the state.

The Yukos case encapsulates all of the challenges that Russia has faced in its transition in that: it grew from the dubious privatization schemes of the 1990s; it corresponded with a lack of transparency as minority shareholders were locked out of key meetings and decisions; it was a venue for corruption as Khodorkovsky stripped Yukos of its assets and sold them for profit; and it served as a catapult for Russia's energy sector to dominate economic growth. The Yukos case also serves as a marker for the establishment and enforcement of the rules governing the market, and their equal application. It raises questions by economists, politicians, and analysts about the Kremlin's actions with regards to the rule of law. The Yukos case also has foreign investors confused: should they sell Russian energy stocks because the country's largest oil company has been made bankrupt in violation of shareholder's rights, or should they buy assets because foreign companies are moving in? Even though the measures that Putin has taken to regain control of the state may seem extreme, this thesis will show that Putin's actions are necessary in order to develop a viable market economy. However, he has fallen short of building the institutions necessary to create a transparent market economy. The next chapter serves to lay the groundwork for evaluating the roots of Russian economic reform and its challenges by analyzing the Gorbachev era.

II. ECONOMIC REFORM PART I – THE GORBACHEV ERA

> All the attempts at partial reform – and there were any number of them – suffered failure one after the other. The country lost its vision of the future. It was impossible to live like that any longer. What was needed was a radical change. That is why I never, ever regretted not taking advantage of the post of general secretary merely to reign for a number of years. I would have viewed that as irresponsible and amoral. I realized that it was an extremely difficult and even risky business to begin reforms on that sort of scale and in our sort of society. Even today I am convinced of the historical correctness of the democratic reforms begun in the spring of 1985.[2]
>
> Mikhail Gorbachev

The burden of being a world superpower and the continuous head to head military competition with the United States contributed to the demise of the Soviet Union. In the early 1980s when Mikhail Gorbachev took office he was soon to discover the full extent of the strain the military complex put on the economy. As the Cold War became increasingly more technology based, the Soviet system was quickly finding itself being left behind as its archaic industries were unable to keep up with the American military machine. Funding the Soviet military was taking as much as 16.5 percent of the total national product and 20 percent of GDP.[3] Some sources have even placed GDP allocation as high as 30 percent of GDP to military production.[4] The Soviet economy could no longer handle the strain and what was to follow was something that no one would have predicted to happen: the great Soviet machine came crashing down, leaving the once feared Soviet state in shambles.

The purpose of this chapter is to explore the roots of economic reform within Russia, specifically during the time of Gorbachev's reign as the general secretary of the Soviet Union. The main question this chapter looks at is what type of economic system

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[2] "Gorbachev Resigns as USSR President," *FBIS-SOV-91-248,* (26 December 1991), 20-21, quoted in Thomas F. Remington, *Politics in Russia*, (New York: Pearson Education, Inc. 2004), 49.

[3] Robert D. English, *Russia and the Idea of the West:* Chapter 6: The New Thinking Comes to Power, http://www.ciaonet.org/book/english/CH-06.pdf, accessed January 2005.

[4] Evegniy Primakov, "Russia Must Be a Star Player in the World Arena," speech, March 14, 1998, 10. The 30 percent figure represents the high end of CIA estimates.

Gorbachev inherited, what its constraints were and how his reforms laid the groundwork for the privatization of the 1990s. In order to answer this question, I briefly examine the nature of the Soviet economic system. I then analyze how the Soviet system affected the decisions that Gorbachev made with regards to economic reform. Finally, I will discuss how these reforms were used as stepping stones for the Soviet Union's eventual demise and laid the groundwork for Russia's movement towards the development of a market economy.

A. GORBACHEV'S INHERITANCE

Vladimir Lenin's vision of socialism encompassed a state that ran all forms of production; from agriculture to education and industry, nothing operated in private hands, and the Communist Party was designed to act in the interest of the people.[5] The communists' long range goal was to overthrow capitalism and establish a socialist system worldwide.[6] In order to reach this goal, Lenin and later Joseph Stalin worked through several models that involved the centralization of the economy. These models included the Five Year Plans.[7] Within each model was a plan for collectivization of industry and agriculture. The belief was that by bringing both under a centralized control system, more goods could be produced in a more cost effective manner. Had the socialist model operated in its pure form, controlling the ownership structure, and all of the control and cash flow rights that were to go with it, the allocation of resources may have remained in balance.[8] However, there was one serious flaw with the socialist model – the Communist party itself. It was up to the Communist party officials and their ministers to decide production levels, prices, levels of investment, wages, et cetera.[9] Nothing was left to

5 Thomas Remington, *Politics in Russia,* 3rd Edition (New York: Pearson Longman, 2004), 31.

6 Ibid.

7 For an in depth description of these plans, please see Martin Malia, *The Soviet Tragedy: A History of Socialism in Russia, 1917-1991,* (New York: The Free Press, 1994), 139-272.

8 For a detailed account of control rights and cash flow rights under Stalin see Boycko, Shleifer and Vishney, *Privatizing Russia,* (Cambridge: MIT Press, 1995), 33-38.

9 See Blanchard, Boycko, Dabrowski, Dornbusch, Layard, Schleifer, *Post Communist Reform: Pain and Progress,* (Cambridge: MIT Press, 1993), 40.

chance, creative thought was crushed and the welfare of the average Soviet citizen was not a concern to the party officials.

Seweryn Bialer's examination of the intricacies of the Soviet command economy and its model for economic growth as described below provides a good background in order to better understand its elements and features. The state, which ultimately meant the Communist Party leadership, owned and controlled the economy. Land, mineral resources, factories, banks, commerce, foreign trade were all nationalized; each was controlled by a state monopoly.[10] The monopolies included governmental organs such as Gossnab (the State Committee for Material and Technical Supply) and Gostroi (the State Committee for Construction) which carried out distribution of resources, while Goskomtsen (the State Committee for Prices), Gosstandart (the State Committee for Standards), and Gosbank (the State Bank) provided the framework within which the economy functioned.[11] The Communist leadership's major aim was its commitment to economic growth. Growth was oriented by goals, which were dictated not by the invisible hand of the market but by the visible hand of the state.[12]

While economic growth was an ambition of the Communist leadership, economic criteria for growth were a low-ranking consideration. What should grow, how fast and at what cost were all decided according to political criteria – in other words, in response to the goals of the leadership.[13] The operation of the economy was highly centralized, and was supervised by a giant bureaucracy organized along vertical lines of authority. The management of the primary units of production and services had very little freedom to decide what to do and how to do it. This, of course, is in complete contrast to Western market economies.[14] The specific objectives of economic development were selective; the aim was not balanced growth. A relatively narrow range of high-priority tasks, such as military goals, were supplied with the necessary resources. Production and

[10] Seweryn Bialer, *The Soviet Paradox,* (New York: Alfred A. Knopf, Inc, 1987), 6.

[11] Mark A. Cichock, *Russian and Eurasian Politics,* (New York: Pearson Education, Inc. 2003), 158.

[12] Bialer, 6.

[13] Ibid.

[14] Ibid.

distribution of consumer goods made do with the leftovers. Thus the Soviet Union was a major military power, but its people had a standard of living inferior to that in the west.[15]

The command planning of economic growth was extremely taut. Overambitious goals were calculated to bring forth the maximum expenditure of effort and energy. The economic reserves left for the element of the unexpected in planning for the future were very limited.[16] Economic growth in the command economy depended primarily on massive and steadily increasing inputs of labor and capital – or in other words, on extensive growth. The rise of labor productivity, innovations and diffusion of new technology – that is to say, intensive development, which was crucial to the West – had been of distinctly secondary importance in expanding the command economy.[17] The directors of the command economy attached critical importance to quantitative indices of achievement. Their incentive system was geared largely to promote higher outputs, far more than higher quality or lower costs. The managers of microeconomic units knew that they would have been severely punished for not fulfilling their quotas. They and their workers also realized that they would get away with shortcomings in quality, diversity and costs.[18] The incentive was to produce more but not better products. The money supply, price mechanism, and credit – were absent or feeble. At best they performed an imperfect and artificial accounting function for the directors of the economy. There was no such thing as consumer sovereignty. Russians could not choose among competing brands. They had to take what the state offered or do without.[19] The Stalinist model of growth and the command economy were designed to be operated in virtual isolation from the outside world. After Stalin's death this total isolation was pierced. But even as late as the early 1980s, Soviet dependence on the world market was marginal.[20]

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[15] Bialer, 6.

[16] Ibid.

[17] Ibid.

[18] Ibid.

[19] Ibid., 7.

[20] Ibid.

With the state guiding the direction of the economy, innovation through competition was non-existent, and the state itself becomes a monopoly. Valerie Bunce argues that by effectively removing boundaries between the political, economic, and social sectors set the Soviet command economy apart from other socialist models. She also argues that;

> state socialism managed to erase not just the already noted boundaries between politics and economics, but also a series of other boundaries that are central to most other political-economic systems; that is, the boundaries separating the public from the private, the state from civil society and the regime from the state. This meant that the public sphere swallowed up the private; civil and political society was either destroyed or prevented from developing; and the state was intertwined with, and quite dependent upon, the regime. When combined, these traits had one core consequence: the governing party in these dictatorships functioned simultaneously as an economic, political and social monopoly. These parties had no economic, political or social competitors, and they were guaranteed – through their monopolistic position and their institutional reach – ready access to economic, political and social resources.[21]

With the state functioning as a monopoly, the state can become inefficient because it prevents the economy from producing the mix of products that have the greatest possible value and quality.[22] Soviet industry did grow under its own version of socialism, but it was not without consequences, especially when one considers its impact on innovation, quality and efficiency. The command economy was developed and refined during the late 1920s and early 30s as Stalin pushed through the first of the Five Year Plans, which were designed to industrialize the Soviet Union quickly and move resources rapidly.[23] In order to achieve this, as was argued by Bialer, the command economy put more emphasis on quantity and rewarded managers for meeting quotas.

In this type of environment there is little incentive for improving on the quality of products produced. One could argue that incentives for reaching quotas could be used to

[21] Valerie Bunce, "The Collapse of Socialism, the Soviet Bloc and Socialist States: An Institutional Account," working papers for Research Group in International Security, http://www.ciaonet.org.libproxy.nps.navy.mil/wps/buv01/buv01.html, accessed April 2005.

[22] Robert Schenk, "Overview Efficiency and Monopoly," Saint Joseph's College, Indiana 1998, http://www.saintjoe.edu, accessed April 2005.

[23] Gregory Grossman, "Notes for a Theory of the Command Economy," *Soviet Studies*, Vol. 15, No. 2. (Oct. 1963), 107, http://links.jstor.org/sici?sici=0038-5859%28196310%2915%3A2%3C101%3ANFATOT%3E2.0.CO%3B2-U, accessed April 2005.

push innovation through to the production lines, but the opposite was generally the outcome. Rather than using the incentives to improve on quality of production, managers often took short-cuts which made the factories a dangerous place to work and had other serious consequences including: a rise in industrial pollution, lack of quality housing, long working hours, scarce food supplies, and in many cases families were forced to share cramped unsanitary quarters.[24]

Another consequence of the Soviet command economy was the development of a shadow economy within the economy itself. This new or second economy was known as the black market or underground.[25] All private business activity was against the law and if caught operating a private business the person would be charged with an economic crime. Even though the punishment of such a crime could result in death, many were willing to run the risk. The types of enterprises these black marketeers engaged in included the sale of banned foreign and black market goods, currency speculation, and private services and repairs.[26] The shadow economy existed to meet the needs of factory managers and consumers that the state was not fulfilling. There were even cases of factory managers who would hire a *tolkatch* (a "pusher" or "expeditor"), who would arrange for goods and deliveries "off the books," when the state Ministries would fail to deliver promised materials.[27] The black market which permeated Soviet society until the fall of the Soviet Union was conducted in such a manner that payments for goods were made partly through cash and partly through political favors.[28]

Those that were successful in the Soviet underground were eventually able to use their skills to their advantage during the mass privatization of the 1990s. By 1991, "central planning was dead, as were its controlling and decision-making institutions, Gosplan, Gossnab, and the ministries. Store shelves were empty. In such near anarchic conditions, those who had developed skills searching out and selling scarce supplies had

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[24] James Wilkinson, H. Stuart Hughes, Contemporary Europe, (New Jersey: Pearson Education, 2004), 251.

[25] Martin Malia, The Soviet Tragedy, (New York: The Free Press, 1994), 207.

[26] Goldman, 123.

[27] Ibid.

[28] Ibid.

an enormous advantage."[29] While most of society had no idea how to function in a market economy, as they had been under centralized control for over seven decades, black marketeers were able to amass fortunes in the scale of billions of dollars.

In addition to the development of a shadow economy, inefficiencies of production would permeate the system and reasonable levels of economic growth were not able to be maintained.[30] This would cause the Soviet Union to experience zero economic growth by 1982.[31] The need to correct these inefficiencies was one of the contributing factors which lead to Gorbachev's economic reforms, including the 1986 creation of Gosagroprom (the State Agro-Industrial Committee).[32] Gorbachev was not the only Soviet leader who attempted to restructure the bureaucratic apparatus for the sake of efficiency; Khrushchev attempted to implement his 'economics over politics' reform in 1962.[33] His reforms, coupled later with Brezhnev's political policies, would provide an outline for the Communist Party that would retain the basic Leninist tenets of state ownership of production and keep the Party as the source of political direction for the state and society.[34]

Another consequence came in the form of weak institutionalized power; as Stalin's political authority was heavily dependent on fear.[35] Stalin's power during his reign was almost absolute and his death, in 1953, brought confusion as to how a successor would be chosen, as there were no set rules or procedures for transferring power.[36] His death also came with the challenge of redefining the institutional framework for ruling the state. The goal of his successors was to strengthen institutionalized power by substituting Stalin's extreme method of rule and replacing it

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29 Goldman, 125.

30 Bunce.

31 English, 195.

32 Malia, 408-409.

33 Cichock.

34 Remington, 34.

35 Ibid., 31.

36 Ibid., 34.

with one that was more rules-governed, with the power of the Party exercised more collectively.[37]

During Khrushchev's reign, he attempted to rally the working class and bind them once again to the Party in an effort to move away from Stalinism. In order to achieve this, he proposed a "mixture of an ideological communist vision and 'goulash communism' – pay incentives – that was to be combined with efforts at enhancing popular participation in communal affairs in order to give the working classes a greater stake in economic progress."[38] While able to moderate the effects of Stalinism, Khrushchev failed in his attempt to make a complete shift as his colleagues considered his reforms to be dangerous, and eventually ousted him in October of 1964.[39]

While Khrushchev's attempt to move the Party away from Stalinism would lead to his downfall, the popularity of Brezhnev's rule within the political elite showed the continuing vitality of Stalinist modes of thinking and management regarding the economy.[40] Brezhnev's reign saw little to no attempts at reforms that would upset the balance of ministerial and regional power centers and very little change to policy with regards to innovation.[41] In the beginning of his reign lack of innovation had little effect on the economy; in fact, during the first decade of his rule, the Soviet Union experienced good overall growth and increased consumption.[42] However, this growth did not last and by the early 1980s, the growth rate would flatten out to zero. Other results included "a drift in policy, worsening government performance, and a gradual aging of the entire ruling elite of the Soviet Union, during which the political system grew increasingly unresponsive to the imperative of economic and political reform."[43]

Unresponsiveness to economic and political reform, inefficiencies within the economic sector, increasing military burdens, and the rise of nationalistic ideologies

37 Remington, 34.

38 Bialer, 10.

39 Ibid., 11.

40 Ibid., 13.

41 Remington, 42.

42 Bialer, 14.

43 Remington, 42.

within the Soviet Union would all be contributing factors that led to Gorbachev's reform movement. Brezhnev successors Andropov and Chernenko were both in office for too short a period to put forth any real changes. Although Andropov initially pushed for reform, Chernenko maintained the status quo of Brezhnev's policies. It would not be until Gorbachev took office that reform would again be mentioned, although no one could predict the extent to which Gorbachev's reforms would impact the economy. Some have even questioned whether or not Gorbachev realized the extent that his reforms would lead to the end of the Soviet Union or if the 'solidarity movement' took him by surprise. This question is beyond the scope of this thesis and I will not address it further except to say that I would argue that it appears that Gorbachev's reforms were at the very least an attempt to save the socialist command economy, at the very most an attempt to create a socialist democracy, but certainly not an overt act to dismantle the system.

B. GORBACHEV'S REFORMS

By the time Mikhail Sergeevich Gorbachev took office as general secretary he had already stated, in a speech in December 1984, his intent to reform the command economy. While the speech could not be considered extremist in nature, he used broad brush strokes to paint a picture that supported reform in order to strengthen the Soviet Union. He attacked the Brezhnev doctrine, introduced the ideas of *glasnost* (openness) and *perestroika* (restructuring), as well as concepts and ideas that other political groups could support. For example, he spoke of anti-corruption elements that the Puritans could relate to, he favored rationalizing the planned economy to gain support of the technocrats, and his overall reform ideas captured the ideas of political reformists.[44] The most striking aspect of the speech was that while it spoke of reform, it was not so radical as to scare the hard core Brezhnev loyalists who were willing to tolerate some reform in the interest of strengthening socialism.[45] As was stated before, the need for reform came

[44] Dr. Jacqueline Hayden, "Unintended Consequences: Gorbachev and the end of the Soviet system," http://www.politics.tcd.ie/courses/undergrad/PO1600/materials/PO1600Lec35.ppt, accessed April 2005.

[45] Remington, 43.

from a variety of factors including the stagnation of the Soviet economy, as inefficiencies within the system continued to grow.

When Gorbachev finally took over the office of the general secretary, he would embark on a path of reform. Bialer categorizes Gorbachev's reforms into four areas; one, to change the managerial and administrative personnel and their reeducation; two, to increase labor discipline; three, reduce central planning and emphasize quality and cost; and four, the centralized mobilization of resources for essential goals.[46] For Gorbachev to enact these reforms he had to overcome the constraints of the command economy.

First, I will discuss his attempts to change the managerial and administrative personnel within the state. Gorbachev's attempts to change the bureaucracy would mean a top-down reorganization of the system. It would also mean circumventing the elite power structure that maintained the Party.[47] Bunce argues that the Party elites were the sole provider of power and privilege within the system, which meant that the Party functioned as the market for all claims to power and privilege.[48]

> The Party elites were unusually "elite sensitive," because the system was composed of-indeed defined by-an elaborate tapestry of dependent relationships that ran from its bottom (local neighborhoods, schools, and the like) to its apex in the Politburo and the Central Committee of the communist party. Thus, if the elites were stable, so was economics, politics, power and personnel.[49]

The elite power structure is the very entity that brought Gorbachev to power and it was the same structure that he, in some cases, circumvented or successfully negotiated in order to push his reforms through.[50] The issue with relying on an elite power structure in this manner is that it can create a significant amount of conflict up and down the structure itself. Conflict arose as members at various levels constantly jockeyed for a favorable position or to gain a valuable connection within the Party hierarchy, which would lead to

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46 Bialer, 153.

47 English, 201.

48 Bunce.

49 Ibid.

50 English, 201.

privileges that could not have been had without the connection.[51] It could be said that Gorbachev used conflict among the elites to his advantage, in that there was already an underlying movement of 'new thinkers' that were ready to challenge the Soviet model of a command economy.[52] The 'new thinkers' arose from a growing number of intellectuals that had various experiences with Western policies and ideologies which would further influence Gorbachev's plans for glasnost and perestroika.[53] However, even with the intellectual elite on his side Gorbachev would still face resistance to his reforms. The resistance came from the conservative right within the Party in that they were generally not ready to deal with the social consequences of ending consumer subsidies and other forms of dependence on the state sector.[54] To take away the crutch of state subsidies could be later interpreted as a flaw when evaluating the effects of Gorbachev's reforms. As far as Gorbachev's efforts to restructure the political system, he pushed for changes to the Soviet constitution, legal system, party rules, and even introduced the idea for democratization. By 1989, it could be said that not much was changed in that after four years of reforms the Communist Party still dominated the political system. However, as Francis Fukuyama argues, what did change within the Party was its ideology, in that some Party members recognized that the root cause of Soviet inefficiency was central planning and the command system itself.[55]

As far as the other three categories of Gorbachev's reforms, they could all be equated to the economic structure itself. The targets of Gorbachev's reforms would be labor, investment and prices. He pushed an agenda for developing a market economy and decentralizing the decision making. He drew from Lenin's experiment of the New Economic Policy (NEP) to push economic liberalization. Laws authorized the Komsomol (Youth Communist League) to develop cooperatives and individual work activities, which amounted to the legalization of private enterprise. Under the guise of the mini NEP, Gorbachev looked to the Komsomol for potential entrepreneurs who could

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51 Bunce.

52 Francis, Fukuyama, "The End of History?" *The National Interest*, (Summer 1989), accessed February 2003, http://www.wku.edu/~sullib/history.htm.

53 English, 207.

54 Fukuyama.

55 Ibid.

test the potential for developing a market economy within Russia. Mikhail Khodorkovsky was an example of who was selected to conduct the Russian market experiment. While studying economics at the Mendeleeva Chemical Technical Institute, Khodorkovsky was the deputy chief of the Komsomol and had the connections necessary to maneuver through the political bureaucracy. He used his connections and created a youth club (Foundation of Youth Initiative), "that was in reality a nascent business under the protective umbrella of the Komsomol."[56] Gorbachev pushed a few new initiatives that would allow the young entrepreneurs a greater freedom to really test the system.

> On December 28, 1987, the central committee of the Komsomol gave its local organizations a new set of financial rules, allowing them to raise and spend money as they pleased and set up their own bank accounts … One of the rules was extremely significant: Komsomol organizations could, in certain cases, mix the *nalichnye* [cash] and *beznalichnye* [non-cash].[57]

David Hoffman in his book *The Oligarchs* gives an in depth description of how Khodorkovsky was able to take advantage of Gorbachev's reforms. Hoffman even admits that not all of the avenues are known as to how Khodorkovsky was able to manipulate the system, as there are few people who are willing to talk about his scheme for turning non-cash into cash. It is assumed higher-ups in the Komsomol turned a blind eye to his dealings and that the central bank actually helped him out. Khodorkovsky was able to manipulate Gorbachev's reforms and create a lucrative business of creating cold hard cash from *beznalichnye* – virtual money that the government used to subsidize factories. Non-cash was virtually worthless and could not be mixed with real cash or *nalichnye*. Factories would pay Khodorkovsky and his fellow technical experts for their help on technical issues with the government subsidies. The subsidies in the past were not allowed to be used as a cash payment for goods or services, yet under the new rule; if the factories were dealing with businesses affiliated with Komsomol they could use the non-cash as payment. Khodorkovsky would then shift the funds through his channels within the banking sector and turn it into dollars. In the end, Gorbachev's reforms

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[56] David E. Hoffman, *The Oligarchs: Wealth and Power in the New Russia,* (Cambridge: Perseus Books Group, 2003), 106.

[57] Ibid, 110.

created an avenue for many young money hungry young people to become very wealthy prior to the fall of the Soviet Union.

While the Komsomol experiment was an attempt to develop a market, Malia argues that while Gorbachev called for decentralization he was not advocating giving up socialist property. By keeping industry under state control, Gorbachev did little more than advocate long term leases; and his economic reforms, though radical by Soviet standards, were not revolutionary.[58] For example, in June 1987, he endorsed a draft Law on State Enterprises, which sought to free industry from the direct control of Gosplan and the central ministries which meant that profits could be used according to how the managers saw fit, whether for increased wages or investment. Yet, by January 1988 when the program was to be implemented the overall socialist plan and ministries remained, so the reform remained a hybrid and not a full reform change.[59]

Yet the "old system was given a shock, and a space for individual initiative had been created that would prove increasingly difficult to control."[60] This aspect was exemplified when Gorbachev stripped his ministers of various control rights including appointing managers, implementing production plans and determining inputs into the industry. These control rights were transferred to the managers without the benefit of controlling the cash flow rights. This meant that the managers could seek to maximize their personal profit through diversion of assets and outputs; this in turn could lead to the disruption of supply chains as managers sold directly to the black market and the state no longer controlled the flow goods. The Communist Party lost control of the managers as they "refused to obey instructions from Moscow."[61] This would later become crucial as by 1989, Gorbachev would separate the judiciary from Party control while not establishing a formal rule of law.[62] It was not that the Party was against establishing a rule of law. On the contrary, both the soviets and the Party were to transform the Soviet

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58 Malia, 419.

59 Ibid., 425.

60 Ibid., 426.

61 Boycko, Shleifer and Vishny, *Privatizing Russia,* (Cambridge: MIT Press, 1995), 39.

62 Remington, 44.

Union into a "socialist state based on the rule of law."[63] The issue that could not be resolved was how to do this when the Party essentially functioned above the law. It appeared that the Party was not capable of such a transformation, and would that to subject it to the law would mean the Party tearing it apart. By not developing institutions toward establishing a formal rule of law, managers were forced to rely on their connections both within the Party and the black market to ensure contracts were enforced. The intricacies of these connections and the roots of corruption within Russia will be discussed in Chapter IV of this thesis.

C. THE AFTERMATH

Gorbachev initiated perestroika and glasnost as a means of reforming the Soviet economy that was in serious decline as a repercussion of its superpower status.[64] By the winter of 1989 it became clear that the Soviet Union was in a serious crisis. It started with the extreme scarcity of goods, then exchange degenerated into barter, and finally the country broke up into local economic units.[65] The government responded to the crisis in the spring of 1990 by preparing plans for a Soviet version of the Polish model of radical economic transition.[66] Another phenomenon occurred, what Malia terms a "revolution of consciousness," which meant the end of Soviet socialism. This revolution called for developing a "base for civil society in personal property and freedom of economic choice,"[67] which is a far cry from the Soviet model that had been adhered to for decades.

By 1990, Gorbachev's reforms had severe consequences to the economy. The first was fiscal and monetary imbalances that were caused by reduced production and consumer shortages. The second consequence was the acceleration of inflation that was caused by the Law of State Enterprises which effectively destroyed the vertical chain of

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63 Malia, 429.

64 Malia, 492.

65 Ibid., 473.

66 For further background on the Polish model see Joseph Rothschild and Nancy M. Wingfield, *Return to Diversity,* (Oxford: Oxford University Press, 2000) 3rd edition, 199-271.

67 Malia, 474.

command without “creating the channels for horizontal exchange among producers, distributors, and consumers that were necessary for a market economy.”[68] As goods disappeared from store shelves, Gorbachev and the ‘new thinkers’ worked on several models to save the dying Soviet economy. There was talk of a “regulated market economy.” At the beginning of 1990 Grigorii Yavlinski produced a plan for shock therapy marketization and privatization, but this was turned down by Gorbachev.[69] In August of 1990, Gorbachev teamed up with Yeltsin and came up with the 500-Day plan. The 500-Day Plan had three provisions that stood out; first, there was to be a massive sale of government assets to soak up monetary overhang; second, the rapid introduction of the market in conjunction with large scale privatization, and finally, it delegated to the republics the power of taxation as well as control over their natural resources.[70] When Gorbachev realized that implementing the plan would mean the demise of the Soviet system he immediately began to back-peddle, called for maintaining the status quo, and set out to bury the 500-Day Plan. Unfortunately it was too late; he had set the wheels in motion and could not stop what was about to happen. Despite all his efforts to ‘save’ the Soviet system, it would be all for naught as the Soviet Empire came crashing down.

The 500-Day Plan would be resurrected by Yeltsin following the August coup. The plan would be later shelved in favor of a more radical policy of “shock therapy” price liberalization that would be carried out by Yegor Gaidor, the prime minister.[71] This and Russia’s path to privatization will be discussed in the next chapter.

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[68] Malia, 476.

[69] Malia, 478.

[70] Ibid., 479.

[71] Ibid., 488.

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III. ECONOMIC REFORM PART II – THE YELTSIN ERA

The reformists had their work cut out for them as the social, political, and legal-fiduciary controls had collapsed with the Soviet Union's break-up. With very little formal institutions in place and the need to quickly establish a free market economy, the paths to privatization that were chosen made it easy for corruption to come to the forefront and infiltrate the system at all levels, as well as give rise to a new class of millionaires called the oligarchs. This chapter will explore the nature of post-Soviet Era privatization; the establishment of a pseudo-liberal market economy; and will provide the background of how Khodorkovsky was able to amass billions during the late 1990s. It will address the questions of: What did Yeltsin do with the system that he inherited from Gorbachev? What methods were implemented to privatize the Russian economy? To what extent did 'shock therapy' pave the way for corruption to infiltrate all aspects of the Russian political system? And how did this system allow for the birth of a new elite class of businessmen and politicians called the oligarchs?

A. YELTSIN'S INHERITANCE

Some analysts argue that Gorbachev's original intent with regards to reform was to save the Soviet Union. Under the influence of the 'new thinkers,' Gorbachev along with his intellectual advisors, eventually pushed for democratic reform within the Union. Gorbachev's idea for glasnost opened the door for Russia to ask for outside assistance from the West, an idea that was unheard of during the Soviet era. By 1991 the Soviet economy was in a virtual tailspin, Soviet GDP had declined 17 percent and continued to decline at an accelerated rate, Soviet debt increased appreciably, and inflation rose at an alarming rate.[72] When Boris Yeltsin came to power, his intentions were fairly clear. Rather than save the Soviet Union, he intended to bury it through privatization and

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[72] "Russia: Unforeseen Results of Reform," *CIA World Factbook,* The Library of Congress Country Studies, http://www.photius.com/countries/russia/economy/russia_economy_unforeseen_results_o~10793.html, accessed May 2005.

democratization.[73] Historically, privatization has contributed to the socio-economic and political prosperity of a nation, although not without a few failures.[74] Privatization, in some cases, is thought to promote economic stability, democracy, and social stability by reducing the power of centralized government and granting it to the ordinary people.[75] It also can encourage competition which results in better products and customer service, whereas state-run economies tend to be inefficient and bureaucratic.[76] For western economies the development of a transparent market did not happen overnight, yet that is precisely what Russia was attempting to do through economic 'shock therapy' (the policy of rapid transition to capitalism).[77] But was the Post-Soviet economy ready for modern day capitalism? The answer to that question could be both yes and no.

It has been argued that Russia was in dire need to break free from the centralized communist system and kick start its economy, but it lacked some of the basic institutions that were in place within western market economies. The institutions that were lacking in Russia included those specified and enforced by the government through a formal rule of law, as well as informal institutions that are generated by having a developed civil society.[78] Yoshiko Herrera argues that economic reform is dependent on political reform, and that to focus solely on market forces will lead to inadequacies in economic reform.[79] Relying solely on market forces was exactly what the reformers did. They relied on the assumption that institutions would come about in their own time, rather than

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73 David E. Hoffman, *The Oligarchs: Wealth and Power in the New Russia,* (Cambridge: Perseus Books Group, 2003), 177.

74 Yuliya Mitrofanskaya, *Privatization as an International Phenomenon: Kazakhstan*, Am. U. International Law Review, 14th ed. (1999) 1399, 1400.

75 Ibid., 1400-02.

76 David Gordon, *Privatization in Eastern Europe: The Polish Experience,* Law and Public Policy in International Business, 25th Anniversary ed. (1994), 517-518.

77 David S. Mason, *Fairness Matters: Equity and the Transition to Democracy,* World Policy Journal, vol. XX, no. 4, Winter 2003/04.

78 *The Czech Transformation – Institutional View,* Faculty of Economics , Masaryk University, Czech Republic, http://www.econ.muni.cz/~quasar.vyuka/transformace/transformace.pdf; accessed on 3 November 2004.

79 Yoshiko M. Herrera, "Russian Economic Reform, 1991-1999," Zoltan Barany and Robert G. Moser, eds, *Russian Politics*, (Cambridge: Cambridge University Press, 2001), 163.

taking the time to push institutional reforms as well as economic reforms.[80] Within the centralized economic structure of the Soviet Union, institutions existed under the state monopolies. It was apparent that the reformers wanted to avoid any influence from the state, yet the state should have taken over the role of coordinating public and private institutions that are necessary for a market economy to function. Herrera brought forth the argument from five Nobel laureates – K. Arrow, L. Klein, W. Leontief, R. Solow, and J. Tobin – to support this claim.

> They argued that this role would involve government support for restructuring and the establishment of market institutions such as property rights, a stable currency, a legal system that could enforce laws and regulate newly privatized enterprises, and an enforceable, simplified tax system. They also stated that many of Russia's present economic troubles stemmed directly or indirectly from the fact that the government did not assume its proper role in a market economy.[81]

Herrera and the Nobel laureates were not the only academics to point out Russia's lack of democratic and market institutions as a cause of Russia's difficult transition. Michael McFaul argued that the Yeltsin regime lacked a clear sense of what it was trying to create and that Yeltsin relied heavily on the advice of neoliberal economists.[82] Richard Ericson also argued that one of Russia's obstacles for a successful transition was institutional, in that Russia's weak institutions lacked a well-defined, protected property rights and a supporting legal infrastructure.[83] Yeltsin's naiveté with regards to institution building and state involvement in a market economy haunted his administration for the rest of the decade.

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80 Herrera discusses the inadequacies of relying on the neoclassical model for economic reform, 163-170.

81 Herrera, 167.

82 Michael McFaul, "Evaluating Yeltsin and His Revolution," Andrew C. Kuchins, ed, *Russia After the Fall,* (Washington D.C.: Brookings Institution Press, 2002), 28-31.

83 Richard E. Ericson, "Economics," Timothy J. Colton and Robert Levgold, eds, *After the Soviet Union,* (New York: W. W. Norton & Company, 1992), 64-67.

B. PATH TO PRIVATIZATION

In 1991, Yeltsin gathered together a group of young neoliberal economists, including Yegor Gaidar, to lay out a plan that would lead Russia down the path to a free market economy. Gaidar apparently believed that Russia would be an ideal area for a market economy. Gaidar and Anatoly Chubais, deputy prime minister, "hoped that all the collectivism, passivity, paternalism, and destruction of initiative and entrepreneurship that was a legacy of Russian and Soviet history would melt away as a beachhead of free markets, free trade, private property, and free prices were established."[84] It was quite a hefty assumption of Gaidar and Chubais that they would be able to pull this off, considering that it had been more than seventy years since the Russian public had been able to think for itself and act on its initiatives.

> The Russian reforms resulted in increasing private properties and economic prosperity, with limited individual freedom. Simultaneously, however, the transition created bureaucracy, powerful state-owned enterprises, lack of rule of law, and uncontrolled corruption.[85]

As argued earlier, the key missing link, appropriate institutional structure, both formal and informal, were not in place when Russia began its reforms.

Rather than focusing on building state institutions that would support the market economy, Gaidar and Chubais's strategy focused solely on economic reforms, including removing price controls, pushing for macroeconomic stabilization, and privatizing state enterprises.[86] In order to make this happen, they committed to "shock therapy" and created a voucher program to privatize the state's assets. They enlisted the aid of Andrei Shleifer, a Harvard economics professor, Maxim Boycko, a Russian economist, and

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[84] David E. Hoffman, *The Oligarchs: Wealth and Power in the New Russia,* (Cambridge: Perseus Books Group, 2003), 182.

[85] Aslam A. Jaffery, *Economic Freedom and Privatization – From Egypt and Mesopotamia to Eastern Europe,* Denver Journal of International Law and Policy, vol 28:4, 374.

[86] McFaul, 29.

Robert Vishny, an economist at the University of Chicago, to help design the voucher program.[87] They identified three main ideas for privatization:

> That people respond to incentives, that political influence is the fundamental economic problem of transition economies, and that the government owns nothing outright and hence the consent of all stakeholders is essential for successful reforms."[88]

Yeltsin sold the voucher privatization to the general populace under the guise that what "Russia needed was millions of owners rather than a handful of millionaires … the vouchers were a ticket for each of us to a free economy."[89] So in October 1992, individuals were able to acquire their vouchers from the state savings bank, Sberbank, for 25 rubles. The nominal value of the vouchers was 10,000 rubles. The vouchers could then be either sold in the private market, invested in private investment funds, or used to bid for shares in companies. The vouchers were tradable, thus allowing individuals to receive cash immediately and large investors to buy up large blocks of shares in voucher auctions. By the end of 1993, 144 million vouchers had found their way into individual hands, and by the end of the voucher program 14,000 firms had been privatized.[90] However, Boycko, Shleifer and Vishny relied on several flawed assumptions. First, that Russian stockholders would act the same as American stockholders; and second, that they took for granted that the existence of property rights automatically guaranteed that the state and the society would enforce those rights.[91] Without a formal rule of law, the Russian economy was ripe for corruption as it moved down the path to privatization.

These assumptions would lead to the ruination of millions of Russians and the rise of a number of shrewd businessmen who would make millions at their expense. Nothing could better exemplify this than the example of the MMM pyramid scheme. David Satter gives a vivid account of the turmoil that followed in the wake of the MMM scandal in his

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87 Marshall I. Goldman, *The Piratization of Russia: Russian Reform goes Awry,* (London: Rutledge, 2003), 73.

88 Boycko et al., 147.

89 Andrei Shleifer, Daniel Treisman, *Without a Map: Political Tactics and Reform in Russia,* (Cambridge: MIT Press, 200), 23.

90 Boycko et al., 110.

91 Goldman, 74.

book *Darkness at Dawn*. Zealous swindlers used the media to promote their voucher funds, which in some cases were merely companies attempting to buy their own shares. Others were simply fronts for dummy firms. "From 1992 through 1994, 800 dummy firms defrauded nearly 30 million Russians of 140 trillion rubles in what became known as the theft of the century."[92] The Russian citizens could be forgiven for their ignorance as they were brought up under a Soviet system where principles of investing did not apply. Russians easily believed the claims of these firms for huge returns on investments, as much as 1,000 to 10,000 percent, simply because it was on TV and in the newspapers. Unfortunately for many Russians, this only served to put a sour taste in their mouths when they saw their life-savings vanish almost overnight, as they only understood that the system was supposed to take care of them and now they had nothing but empty promises.

C. THE RULING CLASS

Without a rule of law in place, a small number of individuals were able to gain an advantage and become millionaires literally overnight. They were able to do this by exploiting Russia's natural resources, especially oil and natural gas. The factories were practically free, and since most of the new owners rarely bothered to pay their employees or their bills on time, most of the revenue earned was pure profit.[93] There were neither regulations that dealt specifically with private businesses, nor were there any competitors, so there were no limits to what these entrepreneurs could achieve. However, the absence of state regulations meant that they had to fend for themselves against criminal and Mafia groups.[94] Those that were able to succeed within the new environment became the new ruling class otherwise known as the oligarchs.

There were three main categories of the new Russian oligarchs: former factory managers, former senior members of the communist-era *nomenklatura*, and those who

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92 David Satter, *Darkness at Dawn: The rise of the Russian criminal state,* (New Haven, Yale University Press, 2003), 75.

93 Goldman, 77-78.

94 Ibid., 103.

prior to 1987 were on the margin of Soviet society.[95] The most common new oligarch was a former factory or business manager of the Soviet era. They coerced their employees to give up their shares of stock "so that they could dominate the makeup of the board of directors."[96] Vladimir V. Kadannikov and Nikolai A. Pugin are prime examples of the converted factory director.

The next category included former members of the *nomenklatura.*

> These officials arranged for the transformation of several state enterprises into non-state joint stock companies and then appointed themselves as managing officers…and gained control of Russia's rich resource endowments, even though for a time at least the state retained a significant equity. In some cases the state continued to be the controlling stockholder."[97]

This was the case of Russia's primary natural gas company, Gazprom. Examples of ex-*nomenklatura* from the raw material sector were Rem Vyakhirev and Viktor Chernomyrdin, and from the oil sector, Vladimir Bogdanov who took over Surgutneftegaz. Vladimir O. Potanin worked in foreign trade and is the president and founder of Oneximbank. From the banking sector arose Vladimir V. Vinogradov.

The third category could be called the upstart oligarchs, as they tended to operate outside the law during the Soviet era. In some cases they operated in the Soviet shadow economy; and in others, they exploited their contacts that they had developed within the Soviet system during the 1970s and 1980s. Alexander P. Smolenski, Vladmir Gusinsky, Anatoly Chubais and Mikhail Khodorkovsky were among those able to use their contacts and become some of the wealthiest men in the world.[98]

In other transition economies it is not unusual to have a business elite. The Russian oligarchs were significantly different, not only in the way they achieved their status, but in the fact that they have significant influence in both the Russian economy as well as the government. The power of the oligarchs could be seen in how they were able

95 Goldman, 103.

96 Ibid., 104.

97 Ibid., 104-105.

98 Ibid., 123-153.

to influence the June 1996 presidential campaign and manipulate the electorate into voting for Boris Yeltsin. At the time, it appeared that Gennady Zyuganov, the Communist Party leader, would win the election, something the oligarchs were loath to see happen as they feared the return to a Soviet era style economy.[99] Yeltsin showed his gratitude by allowing the oligarchs to carve up valuable raw materials, business and media outlets.

By 1999, the Russian elite encompassed the majority of wealth throughout the country, 80-90 percent of the population was in dire straits, and 38 percent were below the official poverty line.[100] The oligarchs were able to gain their status not only through their business savvy, but through the shady backroom deals of the 'loans for shares' program which Yeltsin enacted in 1996. It is interesting to note that the 'loans for shares' program was originally outlined on March 30, 1995 by Vladimir Potanin, the head of Oneximbank, who would emerge as the biggest beneficiary of the program.[101] The pretext behind the program was that bankers wanted to help the government reduce its deficit. The government would put up collateral for loans, from the banker, in the form of government owned stock from larger companies the state was planning to sell. If the loans were not repaid, the banks were free to sell the collateral to recoup their money. These were shares of stock that the state had intended to sell anyway. The banks would then hold an auction on the state's behalf to purchase the collateral.

Correctly done, the companies would yield enough funds to repay the banks and generate for the state a considerably larger amount than the initial loan. In actuality, the auctions were held in remote locations, with the seller setting the terms. These auctions rarely generated more funds than the original loan, and the winner was almost always affiliated with the bank that held the auction.[102] With no restraints or laws to regulate the newly privatized businesses or banks, corners were turned, rents were sought, eyes were blinked, assets stripped and favors rendered.[103] It was through the loans for shares

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[99] Goldman, 1.

[100] Ibid., 2.

[101] Ibid., 4.

[102] Ibid., 3-5.

[103] Ibid., 154.

program that Khodorkovsky was able to acquire Yukos. By 1998, when *Forbes Magazine* released its list of the world's wealthiest 200, for the first time it included five of the Russian oligarchs.[104]

Does this mean that Russia was successful in its privatization efforts? Just looking in terms of numbers of firms privatized, the answer would be yes. But the point of privatization in the first place was to place the formerly state-owned assets in the hands of millions. If you consider that 50% of GDP by 1999 was under the control of eleven oligarchs, the answer would be no.

D. EFFECTS OF YELTSIN'S ECONOMIC REFORMS

From 1991-1998, Yeltsin took the Russian Federation on a roller coaster ride as Russia transitioned from a communist centralized economy to a democratic market economy. There were many obstacles that helped to complicate Russia's reform. These obstacles included: a decentralized political structure that created regional conflict; the concentration of raw materials in a few regions which created economic inequities; and a presidential structure that created a virulent constitutional struggle between parliament and presidency.[105] Schleifer and Treisman argued that given the obstacles, Yeltsin's reformers did make significant achievements during 1992 to 1998.[106] While these achievements resulted in converting Russia to a market economy, Yeltsin's reforms had many effects that directly impacted efficiency, investment, growth, corruption, and social welfare in Russia. As was stated earlier, Russia's ill-developed institutions continued to impact Yeltsin's reforms through the 1990s. When comparing Russian reform to that of the other Warsaw Pact countries, such as Poland and the Czech Republic, some analysts contend that the latter had somewhat of an easier time with their transition as they had old democratic institutions that were suspended while under authoritarian rule and simply

[104] Goldman, 98.

[105] Schleifer and Treisman, *Without a Map,* 20.

[106] Ibid.

had to resurrect those institutions.[107] Russia other the other hand did not and this had several significant impacts on the reform movement.

One of the impacts was related to economic efficiency. Russia's issues with inefficiency dated back to the Soviet era, as was discussed in Chapter II, and this legacy would carry over through its reforms. Yoshiko Herrera argues that there are two reasons why restructuring impacted efficiency. First, despite the liberalization of prices and trade, there was a severe lack of investment. Second, economic reforms were not established under competitive conditions and did not engender further rule-based competition.[108] Without investment, there was no new capital to aid newly privatized firms in restructuring and streamlining their business, which resulted in decreased output and falling wages. It would not be until 1998 when there would be a meager change in employment structure and minor layoffs.[109] By not establishing a competitive market under rule-based competition, industries exercised monopolistic control over goods, and "the legal system did not protect or support the entry of new competitive firms."[110] One of the tenets of a market economy is that competition encourages innovation. In Russia's case, the lack of competition resulted in a decreased level of efficiency, already weak owing to the lack of innovation endemic to the Soviet command economy.

Another impact of Yeltsin's reforms was a low level of outside investment in Russia. Herrera argues there are two reasons for this: one, the government's inability to handle a policy that would produce an attractive investment climate, and two, the lack of legal infrastructure for protecting investment and property rights.[111] The emphasis on stakeholder's rights as well as a general lack of contract enforcement had a negative effect on foreign participation in investment.[112] While Russia needed an influx of capital into its industry, there are mixed views as to where that capital should come from. Charles McPherson, an energy economist from the World Bank, argued in 1996 that joint

107 Schleifer and Treisman, *Without a Map,* 20.

108 Herrera, 152-153.

109 Ibid., 152.

110 Ibid., 153.

111 Ibid.

112 Ibid., 155.

ventures within the oil sector between foreign and domestic interests saw modest increases in production and output as compared to those industries that did not engage in joint ventures.[113] Gains in the energy sector can be attributed to the influx of capital from foreign investors. On the other hand, Anders Aslund argues that foreign investment is not what would lead to a takeoff in the economy. Rather exports and control of capital flight, which amounted to approximately $20 billion a year, are key factors that influence a successful market economy.[114] Initially foreign direct investment (FDI) saw a significant increase during 1996 and 1997. However, insecurity relating to protecting investment and property rights, as well as the financial crisis of 1998, were among the causes for the decrease in FDI, as illustrated in Figure 1 below.

Increment in foreign investment from the preceding year

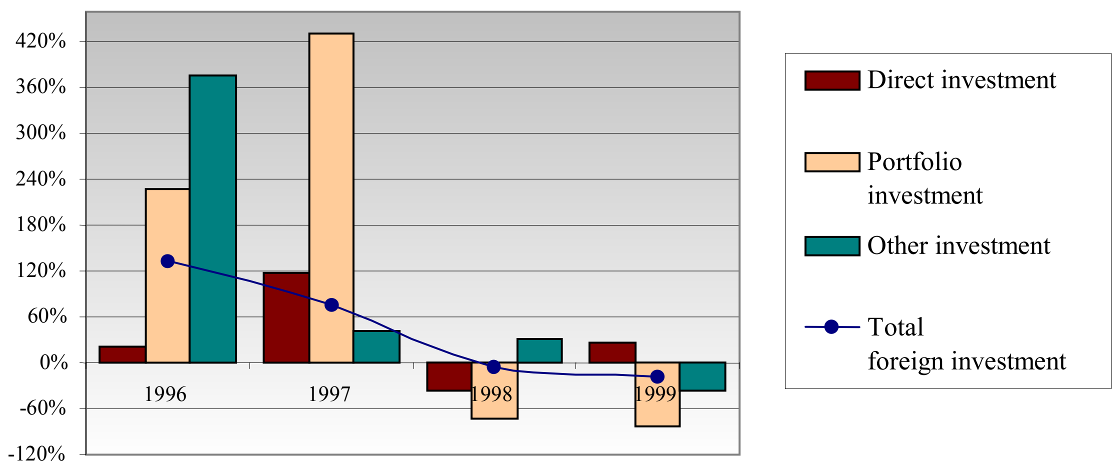

Figure 1. Russian Foreign Investment 1996 through 1999 (From "Russian Economy: Trends and Perspectives," *The Institute for the Economy in Transition,* Issue 21.)

Another issue that is a good indicator of the investment climate was the significant levels of capital flight during the mid to late 1990s, which reached as high as 9

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113 Charles P. McPherson, "Policy Reform in Russia's Oil Sector," *Finance and Development,* (June 1996), 8-9.

114 Anders Asland, "Ten Myths about the Russian Economy," Andrew C. Kuchins, ed. *Russia After the Fall,* (Washington D.C.: Brookings Institution Press, 2002), 118.

percent of GDP during 1998.[115] The Central Bank of Russia estimated that capital flight during 1994-98 averaged $11 billion a year, or approximately $75 per capita. Other estimates of capital flight from Russia range between $10 billion and $20 billion per year.[116] The discrepancy between the estimates is that the estimates of capital flight are limited by the inability to distinguish between legal and illegal capital flows. Figure 2 shows how these estimates were calculated. According to the IMF, Russian authorities sought to decrease capital flight through intensification of exchange controls, tightened tax administration and financial sector supervision.[117]

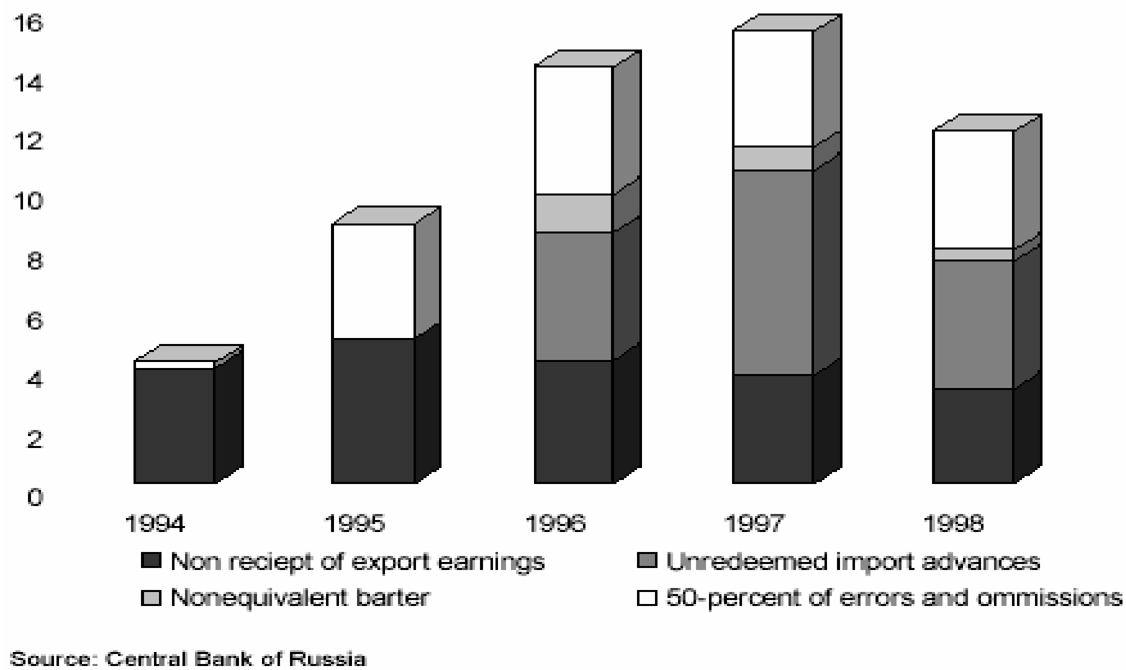

Figure 2. Estimate of Capital Flight from Russia, 1994-1998 (US $ Billions), (From "International Efforts to Aid Russia's Transition Have Had Mixed Results," *Foreign Assistance,* November 2000).

115 Clifford G. Gaddy and Barry W. Ickes, "The Virtual Economy and Economic Recovery in Russia," *Transition Newsletter,* (February-March 2001), posted in *Johnson's Russia List,* no. 5249, 11 May 2001.

116 "International Efforts to Aid Russia's Transition Have Had Mixed Results," Report to the Chairman and the Ranking Minority Member, Committee on Banking and Financial Services, House of Representatives, *Foreign Assistance,* (November 2000), http://www.gao.gov/new.items/d018.pdf, accessed May 2005, 208.

117 "International Efforts to Aid Russia's Transition Have Had Mixed Results," Report to the Chairman and the Ranking Minority Member, Committee on Banking and Financial Services, House of Representatives, *Foreign Assistance,* (November 2000), http://www.gao.gov/new.items/d018.pdf, accessed May 2005, 208.

Effects of Yeltsin's reforms could also be seen by evaluating Russia's growth. When comparing the growth of Russia to other Central and Eastern European and Baltic states, in 1998 Russia's GDP was estimated at 55 percent of the 1989 level which was well below the 95 percent of the other transitional economies.[118] Herrera argues that endogenous institutional development and avoidance of difficult politics were unfortunately part of the neoliberal consensus that contributed to the lack of institutional development in Russia, a deficiency that has and will continue to negatively impact sustainable growth.[119] Unfortunately it would take the financial crisis of 1998 for Russia's corporate sector to address the necessity of institutional reform. After 1998, Russia did start to see positive economic growth, which was attributed to increased oil production as illustrated in Figure 3 below.

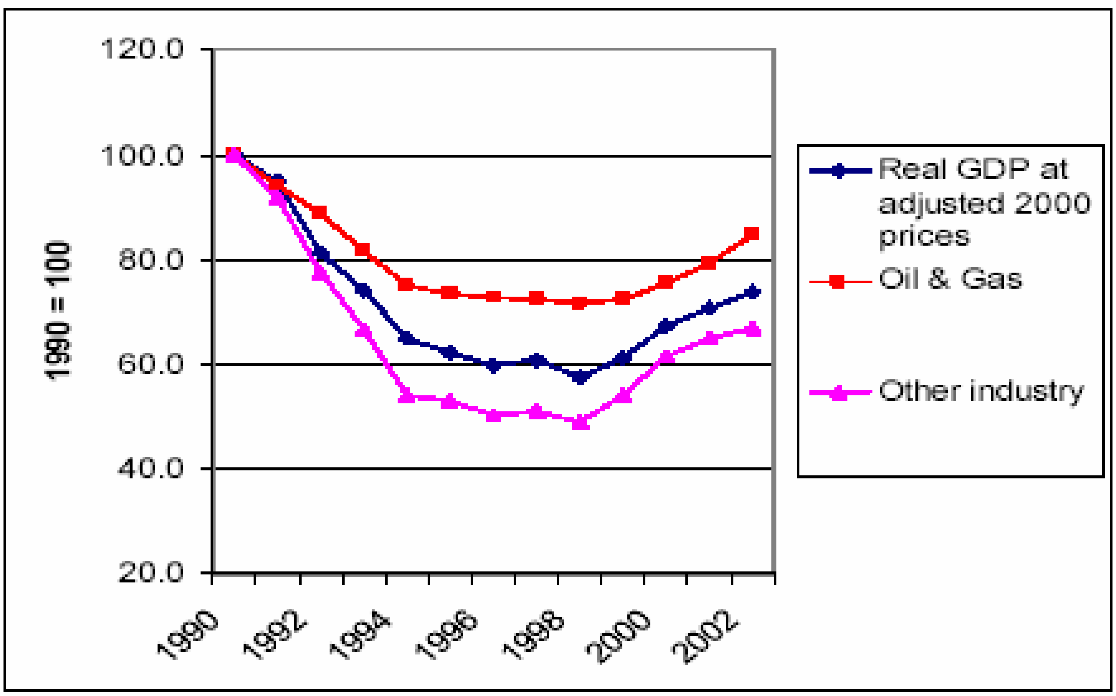

Figure 3. Real GDP 1990-2002: Industry, Oil, and Gas (From "Transition to Development," *World Bank* draft, April 2004, 69)

118 Herrera, 157.

119 Ibid., 160.

Russia's continued reliance on oil revenues would continue to play a significant role throughout Russia's transition and is discussed further in Chapter IV.

The growth of crime and corruption during the 1990s has been the subject of debate as to how much privatization was the cause for its rise. Aslund argues that corruption is not related at all to privatization itself but was connected with law enforcement, tax collection, and the lack of state intervention.[120] Herrera follows along similar lines to that of Aslund in that she argues the rise can be attributed to the "lack of appropriate regulations and institutions that could have given the state information about the economy and made illegal economic activity more costly."[121] It is significant to note that neither argued that privatization itself was the root cause of corruption as some analysts have argued in the past. They do however disagree on whether corruption could have been prevented. Aslund's view follows along the line that the roots of corruption can be seen throughout Soviet history, while Herrera argues that the lack of institutional reform helped to pave the way for the rise in corruption. Further discussion with regards to the roots of corruption is discussed in detail in the next chapter.

The final significant effect that could be related to Yeltsin's reforms impacted the social welfare of Russia. As was stated earlier, the Russian elite comprised of the majority of the wealth in the country while 38 percent of the population was living below subsistence levels in 1999.[122] Income inequality destroyed the sense of fairness in shared costs and economic reform.[123] It also caused the Russian public to distrust the elites as they saw the oligarchs make significant gains while they were left to suffer as a collective whole. An example of this could be found in the health care system, which remained under state influence, where it suffered from the same problems it did under communism including low salaries, low efficiency, and bribery.[124]

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[120] Asland, 114.

[121] Herrera, 161.

[122] Goldman, 102.

[123] Herrera, 162.

[124] Asland, 120.

The lack of development of institutional infrastructure had far reaching effects that touched nearly everything from efficiency, to investment, to growth, to the rise of crime and corruption, and finally impacted the social welfare of the country. With Putin coming to power in 2000, the direction for the Russian economy was to change yet again. The effects of these reforms would seriously influence the direction that Putin would take the economy and are discussed in the next chapter.

E. ENTER THE NEW ORDER

Russia still has much work to do. During the 1990's under Yeltsin, Russia saw the rise of the oligarchs that made their fortunes on often-rigged sales of state assets. When Putin came to power, the public was hoping that with Putin's background in the KGB he would be quick to crackdown on the oligarchs, and he even gave the public some hope that he would eliminate the oligarchs as a class. In a December 2000 interview he stated, "In our country representatives of big business who try to influence political decision making while staying in the shadows have been regarded as oligarchs. There must be no such group of people."[125] His message to the oligarchs was clear; they could keep their ill gotten gains as long as they remained out of the political arena. Putin declared economic growth to be a top priority. During his first term, Putin shifted the direction of the economy since its development under Yeltsin. Putin's actions in the strategic placement of those loyal to him in positions of power within the energy sector and his pursuit of Khodorkovsky and Yukos shows the lengths he is willing to go to in order to regain control of the oligarchs and is the subject of Chapter IV.

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[125] Marshall I. Goldman, *The Piratization of Russia: Russian Reform goes Awry,* (London: Rutledge, 2003), 155.

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IV. ECONOMIC REFORM PART III – THE PUTIN YEARS

When Vladimir Putin became President he inherited an economic system built on corruption, with a weak system to support the rule of law and dominated by a select few who acted only to further their own self interests. Putin's background is steeped in order and the anarchical nature of the Russian state when he took office was the focus of his attack as he worked to push economic reforms and regain control of the state. In his address to the Federal Assembly in July of 2000, he stated:

> We must insure that all of us – entrepreneurs, power structures, all citizens – strongly feel their responsibility to the country. So that strict fulfillment of the law becomes the deliberate choice of all citizens of Russia. Policies built on the basis of open and honest relations of the state with society will protect us from repeating past mistakes, and are the basic conditions of a new 'social contract' Russia needs an economic system which is competitive, effective and socially just, which ensures stable political development. A stable economy is the main guarantor of a democratic society, and the very foundation of a strong nation that is respected in the world. The main obstacles to economic growth are high taxes, corruption among officials and extensive crime. Solving these problems depends on the state. A state prone to corruption, with unclear limits of jurisdiction, will not save entrepreneurs from corrupt officials and the influence of crime. An ineffective state is the main reason for the long and deep economic crisis – I am absolutely sure of this – and we know well the manifestations of this crisis. It is necessary to learn lessons from our experience and admit that the state's key role in the economy is undoubtedly the protection of economic freedom. Our strategic line is as follows: less administration, and more entrepreneurial freedom – freedom to produce, trade, and invest.[126]

In this statement, Putin indicates to the direction in which he hoped to take the country. He wanted to continue with economic reform and create a Russia that had its own identity. It appeared that in addition to shaping Russia's identity he wanted to strengthen Russia and establish a state that ensured freedom – freedom of personality, freedom of enterprise, and freedom of developing institutions of civil societies.

[126] President Vladimir Putin, "Annual Address to the Federal Assembly," July 8, 2000, http://www.kremlin.ru/eng/text/speeches/2000/07/08/0000_type70029_70658.shtml, accessed February 2005.

Following the address, the West breathed a sigh of relief as it appeared that Russia would continue down the path of democracy and market reform. Putin presented an image of order and sobriety, a welcome change to the chaotic temperament of Yeltsin. During the first few years of his presidency, the Russian economy would continue to grow and various reforms aimed at establishing the rule of law would be implemented. Putin's first years would also see him take some actions toward the oligarchs that initially raised some eyebrows. In the beginning, alarm bells did not go off in the international arena – at least not until he jailed the CEO of Yukos, Mikhail Khodorkovsky. In the fall of 2003, Putin's motives began to be seriously questioned in Western capitals. It was time for Russia watchers to start asking questions. They wanted to know if Putin was attempting to establish a transparent free-market economy that abides by the rule of law or whether he was attempting to control the market through political means. What would be the effects of the establishment or disestablishment of the rule of law in the Russian marketplace?

This chapter examines Putin's efforts to drive the economy during his first term as president of Russia. It will answer the following questions. What types of systems were in place when Putin became president, and given its constraints, what type of economy is Putin capable of creating? Should we expect more? Is Putin attempting to establish a transparent free-market economy that abides by the rule of law or is he attempting to control the market through political means? In order to answer these questions, I will examine the steps that Putin has taken in order to clean up the corrupt economic system, and the effects of those decisions. My argument is that given the nature of the Russian economy and the state of its institutions, Putin is doing the best he can given the circumstances.

A. PUTIN TAKES CONTROL

When Putin took office he was constrained by the legacy of the past and the political and social order that he inherited.[127] He immediately picked up the theme of

[127] Richard Sakwa, *Putin: Russia's Choice,* (New York: Routledge, 2004), 60.

"dictatorship of law," as a way of "ensuring the rules apply to everyone."[128] After having controlled Russia for almost a decade, the oligarchs believed they were untouchable. They were able to sway the vote for Yeltsin in 1996, and when it appeared that under Putin they would lose control, they resorted to the media tactics that worked so well back in the nineties.[129] The main difference was that they were not dealing with Yeltsin anymore. While this thesis focuses on Khodorkovsky and Yukos, it is worth mentioning that Khodorkovsky was not the first oligarch to be singled out by Putin. Angered by what he considered an attack on the state by the media, specifically by the two media barons Boris Berezovsky and Vladimir Gusinski, in July 2000, Putin rounded up the oligarchs and laid out the ground rules: they could keep their ill-gotten gains as long as they henceforth played by the rules and stayed out of politics.[130]

Putin worked to regain order by consolidating the state and restoring the vertical chain of government authority that had been destroyed under Yeltsin. "He considered critics and the unruly to be enemies of the state, and therefore his enemies, because he identified the state with the president – that is, himself."[131] In June of 2001, Gusinski openly criticized Putin's actions through his media outlet Media-Most. "The myth of Putin as president who advocates reforms, democracy, free speech, and so on, is history now," Gusinski said defiantly. "His real actions unmask him, revealing his true face, you know."[132] Gusinski was formally charged on June 16 for nonpayment of debts to the state.[133] Gusinski was not the only oligarch to owe the state money, but he did violate Putin's system of loyalty and tried to become a political force in his own right.[134] The Gusinski affair sent two messages to the oligarchs: one, the president was not joking around when it came to maintaining political stability, and two, that prosecutor's office

[128]Jonas Bernstein, "Party Lines: Dictated by Law, or Nods," *Moscow Times,* March 4, 2000.

[129] For a detailed account of the 1996 election see David Hoffman's *The Oligarchs,* 325-364.

[130] David E. Hoffman, *The Oligarchs: Wealth and Power in the New Russia,* (Cambridge: Perseus Books Group, 2003), 497.

[131] Lilia Shevtsova, *Putin's Russia,* (Washington, D.C: Carnegie Endowment for Peace, 2003), 106.

[132] Hoffman, 479.

[133] Ibid., 481.

[134] Shevtsova, 107.

would be used as the guard dog of the new regime and no one had immunity anymore.[135] Western media outlets ran Gusinski's arrest as their lead story. The Western response in general was negative as Western leaders questioned the Kremlin's motives behind the arrest.[136]

The Gusinski affair may have made some of the oligarchs nervous, yet it did not stop Putin's next victim from attempting his shot at the president. Boris Berezovsky had been instrumental in grooming Putin for accession to the presidency; perhaps that is why he felt the need to step up and challenge Putin's consolidation of the state.

> Berezovsky came to the conclusion that if Putin was not stopped from gathering all power to himself soon, he would leave no room for any independent political actors, even those to whom he was obligated. He became the first to openly protest Putin's reform of the Federation Council.[137]

In addition to these protestations, Berezovsky wanted to create opposition to Putin. Once again the prosecutor general's office stepped in and investigated his shady deals of the nineties, specifically Aeroflot, which would eventually force him into exile.

So where do the oligarchs stand? In June 2000, Gusinski was jailed, released after three nights, made for his Sotogrande villa near Kadix in the south of Spain, was then charged with embezzlement, and now lives in Tel Aviv, Israel. Federal prosecutors slapped metals magnate Vladimir O. Potanin with a lawsuit challenging the legality of the privatization of his Norilsk Nickel company; Vagit Alexperov, president of Lukoil, Russia's largest oil company, was charged with tax fraud; and Berezovsky would flee arrest for embezzlement in his dealings with Aeroflot, and live in exile in the United Kingdom.[138] Following the Berezovsky incident, the remaining oligarchs appeared to tow the line, in order to avoid scrutiny.

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135 Shevtsova.

136 Ibid.

137 Ibid., 113.

138 "Boris Berezovsky: Tycoon under Siege (int'l edition)" *Business Week Online,* July 24, 2000, http://www.businessweek.com/2000/00_30/b3691184.htm, accessed March 2005.

Khodorkovsky took an entirely different path than the rest; in 2000, he decided to embrace Western-style corporate governance practices.[139] He cleaned up Yukos' accounting practices and published fairly transparent reports of its activities (including major shareholders).[140] Yukos began to emerge as Russia's shining star to western investors as the oil conglomerate paid out dividends for the first time to its shareholders in January 2001.[141] With Yukos' star on the rise, what was it about Khodorkovsky and Yukos that triggered the investigation that would eventually land Khodorkovsky in jail and Yukos auctioned off for a fraction of its net worth?

There are many theories of what actually triggered the investigation. The first theory is that "Putin ordered the crackdown as part of an election campaign strategy based on doing battle with the oligarchs. This was a tactical decision with guaranteed voter appeal calculated to ensure a first round victory for Putin."[142] A second theory goes back a few years to when federal security services went after Vladimir Potanin. They demanded that he pay the government $140 million for what they called the undervalued privatization of Norilsk Nickel. Rumor has it that they secretly asked for money, and that Potanin agreed. If he had not, some of his people would now be behind bars. Then they went after Yukos, again with their hands out, but Khodorkovsky did not pay.[143]

The third revolves around Russia's natural xenophobia, in that Yukos was becoming more transparent than Putin was comfortable with. Yukos at its pinnacle was Russia's top oil producer, pumping 1.7 million barrels of oil a day, or 2 percent of the world's supply. Yukos pushed Russia to the forefront in 2002 as it became a viable alternative to Middle Eastern oil. Khodorkovsky even met with Condoleezza Rice in

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139 Erin E. Arvedlund and Simon Romero, "Kremlin Reasserts Hold on Russia's Oil and Gas," *The New York Times,* December 17, 2004.

140 Peter Rutland, "Russia in 2003," *Transitions Online,* February 2004, http://www.tol.ez, accessed February 2005.

141 "YUKOS announces new dividend policy and interim dividend of USD 100 million," Press Release Moscow, October 26, 2000, http://www.yukos.com/new_ir/Press_releases.asp, accessed March 2005.

142 Vitaly V. Shlykov, "The Anti-Oligarchic Campaign and its Implications for Russia's Security," Paper for the Conference on "Russian Security and the Continuing War on Terrorism," September 16-17, 2003, Naval Postgraduate School, Monterey, CA.

143 Ibid.

Washington to further U.S. interest in Russian oil; he visited Houston for energy summit meetings, and he pushed for Russia to start shipping oil to the United States.[144] In February 2003 Yukos began the process of merging with Russia's fifth largest oil company, Sibneft; a subsequent merger with Exxon Mobil was also being discussed; and Khodorkovsky was promoting a new Yukos-built pipeline to China, which would break the monopoly of state-owned Transneft Corporation on Russia's oil exports.[145] What troubled Putin, at least according to reports in the Russian media, was that a private energy giant was making decisions and headlines that were usually reserved for those in power behind Kremlin walls.[146] Another troubling item for Putin was that should Yukos sell off part of its holdings to a Western oil company, it would mean that foreign investors would now have a controlling interest in a Russian based firm. For a country so dependent on its oil revenues, this might have been too much for Putin to stomach.

A fourth theory behind the breakup of Yukos had to deal with Khodorkovsky himself. He became active politically, thereby turning the Kremlin's focus back to him as he broke the fundamental rule of staying out of politics. Khodorkovsky did not back one political party in particular, but generously funded across the political spectrum,

> from the liberal Yabloko to the Communists. Experts speculated that Yukos could end up controlling one third of the seats in the State Duma that was to be elected in December 2003. Yukos was active in buying the loyalty of Duma deputies, and did not hesitate to use its leverage to block legislation it disliked, such as higher oil excise taxes and revisions to the law on production sharing.[147]

Yukos was not the only firm to oppose the tax changes that Putin was attempting to implement.

> But as Alexei Kudrin, the finance minister, told a Russian magazine, *Kompania,* in February, in the only admission from on high that the case was political: 'Other companies lobbyists did not behave so aggressively.' Yukos' people, he said, 'came to me and talked directly about laws that didn't suit them: Alexei Leonidovich, we won't let you get your decisions

[144] Arvedlund.

[145] Rutland, "Russia in 2003," 5.

[146] Arvedlund.

[147] Rutland, "Russia in 2003," 6.

> through the Duma, no matter what it costs us.' They meant it. At a reading of the tax bill in June last year, even the Communists, usually no friends of the oligarchs, voted against it. So, Mr. Kudrin said the Yukos affair was 'inevitable, not in the personal sense, but in the sense of a clarification of the rules of the game'.[148]

If exerting pressure through the Duma was not enough, there was even speculation that Khodorkovsky himself would run for president in 2008.

Khodorkovsky did more than just dabble in the political arena; he became one of the driving forces behind attempting to establish a 'civil society' in Russia. He established pro-democracy projects through his Open Russia Foundation. With an annual budget of $12 million, the Foundation's objective was to promote liberal and democratic society by supporting the country's most active and talented citizens who wish to live, work and succeed professionally in Russia. The Foundation supported a range of projects in the areas of education and culture, including the sponsorship of young Russians in the arts and sciences, the Federation of Internet Education, teacher training, computers for schools, and clubs for regional journalists.[149] Khodorkovsky's philanthropic efforts could almost equate him as the Russian version of George Soros.[150] However, Nataliya Veshnyakova, from the Russian Prosecutor Generals Office, argues that the foundation was actually a front to illegally divert Yukos assets.[151]

Khodorkovsky was more than just Yukos; he was becoming the most influential person in Russia next to Putin himself. He certainly was the wealthiest. In 2003, in its annual ranking of the world's wealthiest individuals, *Forbes Magazine* ranked Khodorkovsky 26th overall and number one in Russia, with a net worth of over $8

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148 "Taming the Robber Barons," *The Economist,* May 20, 2004

149 "Biographies: Mikhail Khodorkovsky," http://www.khodorkovskytrial.com/about/mbk_bio.cfm, accessed February 2005.

150 George Soros is chairman of the Open Society Institute (OSI) and the founder of a network of philanthropic organizations that are active in more than 50 countries. Based primarily in Central and Eastern Europe and the former Soviet Union, these foundations are dedicated to building and maintaining the infrastructure and institutions of an open society. For more information visit the OSI website at http://www.soros.org, accessed February 2005.

151 "Prosecutors hint at new charges," *Radio Free Europe/Radio Liberty,* RFE/RL newsline, vol. 9, no. 92, part I, 16 May 2005.

billion.[152] Khodorkovsky had effectively gained influence throughout almost every political and economic arena in Russia. Perhaps he did not believe that his outspokenness and political dabbling would bring the Kremlin down on him or perhaps he felt his stature in society gave him some form of immunity, either way the result was the same – in October of 2003, Mikhail Khodorkovsky was charged with tax evasion and subsequently sent to jail.

Following Khodorkovsky's arrest, westerners and investors alike immediately began to wonder what Putin was up to. Putin again met with business leaders and told them "the business community could also put some effort into developing a system of new social guarantees" and "help support transformations that have now begun in the armed forces, the housing and utilities sector, health and education."[153] They could contribute in any way to help encourage a civil society, just so long as they stayed away from playing political games. The oligarchs were again quick to support Putin.[154] Foreign investors, economists and scholars were not so quick to let Putin off the hook. They questioned his motives for Khodorkovsky's arrest and his commitment to establishing a transparent market economy. However, not everyone was against Putin's actions. Nearly two-thirds of Muscovites polled by the respected VTsIOM-A agency were skeptical about Kremlin assertions the YUKOS affair was purely a criminal matter and saw Khodorkovsky's arrest as political. However, support for Putin remained high. The VTsIOM-A poll said Putin had 73 percent approval among 1,600 Russians polled in October of 2003.[155] While this was nearly his lowest score during 2003, it was well above his rating after he came to power in 2000 promising to enforce the law and end the chaos of the 1990s, when the oligarchs, like Khodorkovsky, amassed their vast wealth.

Another VTsIOM-A poll conducted in 2003 evaluated the general populace's attitude towards the government reviewing the results of the privatizations of the 1990s,

152 "World's Richest People," *Forbes.com,* February 27, 2003, http://www.forbes.com/2003/02/26/billionaireland.html, accessed March 2005.

153 "Taming the Robber Barons."

154 Ibid.

155 "Russians support Putin over Yukos," cnn.com/World, November 1, 2003, posted 8:38am EST (1338 GMT), http://www.cnn.com/2003/WORLD/europe/11/01/yukos.putin.popularity.reut/, accessed February 2005.

showed that 37 percent believed that all property privatized should be returned to the state as compared to the 31 percent who believed that the property should be returned to the state only in cases where illegality was proved.[156] This can be interpreted that the Russian public is supportive of the government conducting reviews of the privatizations of the 1990s. However, the same poll showed that 41 percent of the public believed that reviews of the 1990s privatizations would harm the political situation in Russia as compared to the 48 percent that believed the reviews would help Russia's economy.[157] In a subsequent poll, conducted in January 2004, when asked if they believed that the politicians and oligarchs had unlimited power and were able to whatever they pleased, 86 percent of those polled said yes, that both the politicians and oligarchs could do whatever they pleased.[158] This is a change from a poll conducted in August 2001 in which 69 percent of the public believed that oligarchs hired the state for their own purpose.[159] A letter from the editor of the *Moscow Times* summed up the general feeling of the populace with regards to the Khodorkovsky affair. The letter was highly critical of the corrupt loans for shares deal and calls the judicial review "a breath of fresh air," and goes further in criticizing the oligarchs themselves saying that they "massively shortchanged the state" and "were a step backward rather than forward in the critical task of developing a culture with respect for the rule of law, and they generated wholesale popular cynicism about Russia's variant of capitalism."[160] Whether or not the Kremlin's motives for Khodorkovsky's arrest were completely legitimate in seeking to recover back taxes that Yukos owed the state or they were political, one thing is remarkably clear; Putin is realigning the political and economic structure of the state.

[156] Nationwide VTsIOM survey, 17-21 July 2003, N=1585, accessed May 2005, http://www.russiavotes.org/privatization.htm.

[157] Ibid.

[158] Levada Center, nationwide survey, 23-26 January 2004, N=1601, accessed May 2005, http://www.russiavotes.org/Yukos_cur.htm.

[159] Nationwide VTsIOM survey, 24-27 August 2001, N=1600, accessed May 2005, http://www.rusiavotes.org/Yukos_cur.htm.

[160] "Rule of Law Needed Before Market Stability," *Moscow Times,* October 31, 2003.

B. PUTIN'S INHERITANCE

In order to better understand Putin's motives for breaking the oligarchs' hold on Russia, it is important to take a closer look at the economic system that Putin inherited and his motivations behind his vertical realignment of the state. As was stated in the previous chapter, during the nineties Russian society had been taken on a roller coaster ride of financial highs and lows, including privatization schemes that stripped the average citizen of their life savings while a select few were able to amass obscene amounts of wealth. What the previous chapter did not discuss was the extent to which corruption had infiltrated Russian society.

Corruption resided not only at the elite levels, but had worked its way into almost every business from the energy giants to the smallest mom-and-pop establishments. Why was corruption so prevalent in the Russian economy? Two scholars, Stephen Holmes and Nina Khrushcheva, offer up cultural explanations for the rampant corruption. Holmes argues on the basis of "cultural legacies," "habits acquired in the past, which are difficult to shake and which purportedly obstruct the successful creation and function of democratic and market institutions. Old habits die hard and mentalities change slowly."[161] Khrushcheva delves into the realm of the Russian "national character" and looks at the influences that have created the "values that linger from the previous system which reinforce the special role of family and friendship relationships for a Russian."[162] She argues that, "the influence of these factors leaves little hope for a 'faceless bureaucracy' that would operate without regard to personal preferences and sympathies, applying the law and regulations equally to all."[163] But does that mean that Russia by nature is more corrupt than other developing states? This precise question was tackled by Andrei Shleifer and Daniel Treisman. They argue that

[161] Stephen Holmes, "Cultural Legacies or State Collapse: Probing the post-communist dilemma," Public Lectures No 13, delivered at Collogiem Budapest, October 17, 1995, 4.

[162] Nina L. Khrushcheva, "Cultural Contradictions of Post-Communism: Why liberal reforms did not succeed in Russia," A paper from the Project on Development, Trade, and International Finance, *Council on Foreign Relations,* 2000, 3.

[163] Ibid.

> once one takes into account Russia's level of economic development, federal structure, and lack of exposure until recently to democracy or free trade, its level of perceived corruption in the late 1990s is close to what one would expect … Russia is not trapped in a quagmire of corruption by the ingrained cultural traits of ordinary Russians or by an insurmountable historical legacy. And corruption, by itself, is not a sufficient explanation for the country's failure to grow. Rather, corruption is a symptom of underlying institutional problems.[164]

The lack of institutional reform has been one of the underlying themes of this thesis and will remain so when discussing the roots of corruption in Russia. Oliver Blanchard, Maxim Boycko, Marek Dabrowski, Rudiger Dornbusch, Richard Layard, and Andrei Shleifer, in their book *Post-Communist Reform*, believed that liberalization did not create corruption or the mafia, but that it had existed within communist institutions and later flourished in the two-price system where the privileged buy at lower prices and sell illegally at high ones.[165] They argue that anyone with the power to prevent movement of goods can always extract a rent. But they make the assumption that a legislative infrastructure that would enforce the rule of law would be implemented. Unfortunately, establishing respect for the rules was not a priority; it was always assumed that it would come with time. Marshall Goldman, in the *Piratization of Russia,* gives a pointed critique of Boycko *et al,* in that they "took for granted that the existence of property rights automatically guaranteed that the state and the society would enforce those rights. This assumed that there was something like the 'rule of law' and that the state would not be in a condition of near anarchy."[166] They also say that in order for their theory to work, there should be "an appropriate institutional structure in place."[167] Yet at the beginning of the reform, no form of market or democratic institutions existed. Even Peter Rutland points out "the reformist leaders gave higher priority to avoiding a return to the past than building new institutions for the future. Promoting respect for the law, effective regulatory institutions or a healthy civil society was simply not on their

[164] Andrei Shleifer and Daniel Treisman, *Without a Map: Political Tactics and Economic Reform in Russia,* (Cambridge: MIT Press, 2000), 104-105.

[165] Blanchard, Boycko, Dabrowski, Dornbusch, Layard, Schleifer, *Post Communist Reform: Pain and Progress,* (Cambridge: MIT Press, 1993), 22.

[166] Marshall I. Goldman, *The Piratization of Russia: Russian reform goes awry,* (New York: Routledge, 2003), 74.

[167] Boycko, Shleifer and Vishney, *Privatizing Russia,* (Cambridge: MIT Press, 1995), 10.

agenda."[168] With no one and no institution in place that could effectively enforce the rules or garner respect for the law, and with pre-existing institutions that fostered corruption minority investors were often faced with locked doors and the average Russian citizen was left to fend for themselves.

An alarming trend started to permeate the Russian economy during the early years of the reform. The court system did not enforce property rights laws. New business owners, instead, resorted to using criminal groups to enforce contracts and provide security.[169] Rutland quotes Yulia Latynina as she gives a colorful description of how the oligarchs used the criminal groups:

> Back in the late 1980s, when the future oligarchs were just getting started in a frenzy of dirt and blood, each faced an impossible task: dealing with the thugs who walked into their offices, stuck guns to their heads and demanded money, without turning into thugs themselves. They solved this problem by amassing security forces and privatizing the state along with the cops and the prosecutors. They took care of the thugs and the "red directors. Then, instead of disarming and disbanding their privatized police forces, the oligarchs began to battle one another. They taught the prosecutors how to use criminal investigations to pry factories away from their owners. They created Frankenstein, but Frankenstein did not obey his master for long.[170]

When Khodorkovsky acquired Yukos, he sent three hundred of his security men to physically take over the refineries and oil wells.[171] He used his security force to ensure the company knew who was boss and that he would not tolerate falsifying the books from the financial officers or accountants. This was the only way to ensure that he retained control of his new company as there was no other set of institutions that could guarantee his property rights.

Private security forces, and their criminal counterparts, filled the gaping hole that the state was not able or willing to fill. Vadim Volkov offers up what is perhaps the most

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168 Peter Rutland, "Business and Civil Society in Russia," Forthcoming in Alfred Evans and Laura Henry eds. *Civil Society in Russia,* (draft 2004), 5.

169 Federico Varese, *The Russian Mafia,* (New York: Oxford University Press, 2002).

170 Yulia Latynina, "Who is the Biggest Loser," *Moscow Times,* October 29, 2003, quoted in Rutland "Business and Civil Society in Russia."

171 David E. Hoffman, *The Oligarchs: Wealth and Power in the New Russia,* (New York: Public Affairs, 2003), 446.

in depth argument for the origins of Russia's corruption. He argues that most theories assume the state is present; in Russia, the structural presence of the state was in fact absent in the early nineties. The absence of the state effectively created a new competitive market for protection. The conditions are set by individuals to form protective agencies from the bottom-up. These agencies are made up of individuals who were either previously employed in the Soviet security forces, whose jobs were wiped out when the power structures of the centralized state were weakened, or youth groups – former athletes that were closely linked to the Soviet militia or military. Volkov dismisses the cultural argument that Russia can never change. He argues that Russia is simply going through the natural process of gaining control, first through taxation, judicial reform, and law enforcement.[172] Shleifer and Treisman argue along the same lines as Volkov in that at the stage of Russia's transformation, administrative corruption, organized crime, financial crisis, hyperinflation, and back-room political dealing is perfectly normal.[173]

Volkov also argues that the criminal groups and protection agencies went through the same growth processes that the oligarchs went through, as they initially implemented their own form of asset stripping. In their early stages the groups "were excessively cruel and predatory on the businessmen from whom they collected protection money: 'they are completely irrational, they rip off their own businessmen and do not let them develop'."[174] They acted as the oligarchs did, preferring short-term gains over sustained 'stationary' protective relationships. As profits started to dip, they were tempted by incentives to go legit. They looked into investments and enforcement of contracts, and through working with the companies they were protecting they were able to increase the company's profits, in turn increasing their own. The protection agencies found it was better to feed off the real economy rather than work against it. So, as they approached protection as a business proposition, they learned to move and flex with the market in order to survive. The protection agencies became rational actors behaving in a rational

172 Vadim Volkov, *Violent Entrepreneurs,* (London: Cornell University Press, 2002).

173 Andrei Shleifer, and Daniel Treisman, "A Normal Country," NBER Working Paper Series, working paper 10057, http://nber.org/papers/w10057, accessed July 2004.

174 Volkov, 111.

way in response to economic factors. These protection agencies became Russia's answer to dealing with the need to protect property rights and the basis for a shadowy system of arbitration.[175]

C. PUTIN'S POLICIES

This system of corruption and privatized enforcement of property rights is what Putin inherited and what he vowed to clean up in his July 2000 Address to the Federal Assembly. He immediately put the wheels in motion to regain control of the state, first in his conference with the oligarchs laying out the new ground rules, second by implementing new tax reforms to encourage businesses and individuals to pay their taxes, and finally by strategically placing those loyal to him in various power positions within the government and the economy. The new ground rules have already been discussed at length as well as the impact of violating those rules.

Putin's second action dealing with tax reforms included the implementation of a 13 percent flat tax on income. The lower marginal tax rates produced higher revenues as both new and previously concealed economic activities entered the tax base. In November of 2002, it was reported that the revenues generated were equal to roughly 16 percent of Russia's GDP.[176] "There was a huge, monstrous non-compliance problem with the old system," says Dr. Richard Vedder, an Ohio University economics professor. Dr Vedder stated that a lot of people tended to use payment in kind rather than cash for goods in order to evade having to pay taxes. "That problem, from what I understand, has not totally disappeared but has dramatically declined in the last year or two."[177]

Putin's third action and perhaps his most controversial was that of placing those people loyal to him in positions of power. The Institute of Sociology of the Russian Academy of Sciences conducted research on the Putin elite during the years of 2001-

[175] Volkov. 19.

[176] Deroy Murdock, "Russians Do Taxes Right," *National Review Online,* March 1, 2002, http://www.nationalreview.com/murdock/murdock030102.shtml, accessed March 2005.

[177] Ibid.

2003. The result of the study shows that the staffs of the presidential envoys in the seven federal districts have "experienced the most precipitous invasion of military personnel (up to 70 percent of the total)."[178] It finds that "serious changes have occurred at the regional level as well. The number of people with a military or security background has more than doubled over the past three years. 35 percent of those working in economic ministries have a military or security background."[179] The study reveals the curious fact that during the first three years of Putin's presidency the elite has become more militarized and less intellectual.[180]

Putin's realignment of power was something that he had envisioned long before he was elected president. When Putin was appointed as the first deputy to the chief of the presidential administration, he was placed in a position in which he had direct contact with the regional governors. In an interview Putin spoke of his interactions with the governors and gave what could be considered a prophetic statement: "Everyone was saying that the *vertical*, the vertical chain of government, had been destroyed and that it had to be restored." When asked if the governors were ready to line up under the *vertical*, Putin replied "they are. After all, the governors are part of the country, and they also suffer from management weaknesses. Not everyone is going to like everything. You can't please everybody, but you can find some common approaches."[181] So, Putin worked to consolidate power by placing fellow Saint Petersburgers in positions of loyalty. Shevtsova argues that Putin was following his gut instinct and implemented a system of subordination. "His instincts, honed in the power structures, provided simple guidance: control everything, trust no one, be strong because power is the only thing people understand."[182] In order to build his vision, he started with the power ministries to appoint men loyal to him. Secretary of the Security Council Sergei Ivanov, Putin's closest ally, was named minister of defense. Boris Gryzlov, the leader of the Unity

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178 Shlykov.

179 Ibid.

180 Ibid.

181 Vladimir Putin, *First Person,* with Nataliya Gevorkian, Natalya Timokova, and Andrei Kolesnikov, translated by Catherine A. Fitzpatrick, (New York: Public Affairs, 2000), 129-130.

182 Shevtsova, 97.

faction and also Putin's man, became the new minister of the interior.[183] Putin did want to continue to push for market reforms, so he brought economic liberals into the government. They were German Gref, Andrei Illarionov, and Alexei Kudrin, all men he knew from Saint Petersburg. He then turned to state-owned industries intending to gain control of the monopolies. His first target was Gazprom. He replaced Rem Vyakhirev with his own man from Saint Petersburg, Alexei Miller.[184] Anatoly Chubias was a part of Yeltsin's reform party and he headed RAO UES, the Russian electric utility. When Putin came after RAO UES, Chubias pushed back by drawing up a reform draft for the utility.[185] After some debate, Chubias remained head of RAO UES; his being a fellow Saint Petersburger probably did not hurt.[186] However, the recent power outage in Moscow has placed Chubias in the spotlight. The Vremya novostei on 27 May noted that Chubias is "the last director of a fundamental state natural monopoly who is not a man of Putin's team," and speculated "that the goal of the criminal prosecution of the case could be to enable Moscow municipal authorities to take over Mosenergo or to form a rival concern."[187]

In addition to the various appointments, Putin moved to gain control of the larger private energy companies by pressuring the remaining oligarchs to join the Russian Union of Entrepreneurs and Industrialists (RUEI). With Arkady Volsky, Anatoly Chubias, Vladimir Potanin, and Mikhail Khodorkovsky all incorporated into the RUEI, Putin had achieved his goal of getting all the industrialists and oligarchs in one place and under his control, without having to renationalize the privately owned companies.[188] Loyalty was the main issue for Putin. He used the very simplistic method of dividing everyone into two groups; those that were loyal and those that were not. Gusinski, Berezovsky, and Khodorkovsky are all examples of what would happen should this system of loyalty be violated. Companies that currently fall in line with Putin include

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183 Shevtsova, 177.

184 Ibid., 188.

185 Ibid., 189.

186 Ibid.

187 Quoted in "Newspapers Speculate on the Political Fallout from the Blackout," *Radio Free Europe/Radio Liberty*, RFE/RL newsline, vol., 9, no., 101, part 1, 27 May 2005.

188 Shevtsova., 180.

Rosneft, which is state-owned; TNKBP, whose CEO is Simon Kukes and a Putin loyalist with no privatization scandals in his background; and Lukoil's CEO, Alekperov, is loyal to the authorities.

D. EFFECTS OF PUTIN'S ECONOMIC POLICY

Putin's economic policies, from the time he took office through 2003, focused on establishing political and economic institutions that would stabilize the Russian economy. This entailed creating some of the fundamental institutions of a market economy to include civil, tax, budget, labor and land codes, and pension law. Putin's government also lifted administrative barriers to the entrepreneurial activity, improved the relationship between the federal, regional and local budgets, and approached the natural monopolist's reform.[189] The implementation of these reforms furthered Russia's progress in economic reform and helped to secure its economic growth. By 2004, GDP had increased by 7.1 percent, having grown from 10 percent in 2000, 5 percent in 2001, 4.3 percent in 2002, and 7.3 percent in 2003.[190] Much of the growth in GDP can be attributed to higher oil prices which averaged $27 a barrel in 2003, hit a high of $48 per barrel in 2004, and led to a budgetary surplus of R70 billion.[191] On paper, the numbers show Russia to be well on its way to developing into a stable market economy. Unfortunately, once one looks beneath the surface several problems can be seen.

The first problem is that Russia has emerged as a petrol-state and is dangerously dependent on oil and natural gas exports and is particularly vulnerable to fluctuations to world oil prices.

> A $1 per barrel change in oil prices will result in a $1.4 billion change in Russian revenues in the same direction—a fact that underlines the influence of oil on Russia's fiscal position and its vulnerability to oil

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189 S. Zhavoronkov and V. Norikov, "Russian Economy 2004: Trends and Outlooks," *Institute for the Economy in Transition,* Issue 26, (March 2005), 14, accessed May 2005, http://www.iet.ru/files/text/trends/2004eng/2004eng.pdf.

190 Peter Rutland, "Russia in 2003," *Transitions Online,* (February 2004), 24, accessed February 2005, www.tol.cz.

191 Ibid.

> market volatility. The government's stabilization fund, a rainy-day storage facility for windfall oil receipts that came into effect on January 1, 2004, can help to offset oil market volatility. But as the fund grows (it is currently worth approximately $16.7 billion), using it to solve social problems or to buy other assets in the Commonwealth of Independent States (CIS) may become more likely. Although estimates vary widely, the World Bank has suggested that Russia's oil and gas sector may have accounted for up to 25% of GDP in 2003 while employing less than 1% of the population. Raw materials, such as oil, natural gas, and metals, dominate exports and account for over two-thirds of all Russian export revenues.[192]

Related to Russia's dependence on oil as identified in 2001, by Putin's economic advisor Andrei Illarionov, was that Russia was showing early signs of "Dutch disease."[193] Rutland argues that two sets of prices in the Russian economy are out of line: the price of the ruble itself (the exchange rate) and the price of energy. With regards to the ruble, "for reasons of inertia and prestige, the government chooses to try and maintain a relatively fixed nominal ruble exchange rate against the dollar."[194] By fixing the ruble to the dollar and not allowing its value to fluctuate, higher inflation and import competition leading to an erosion of trade surplus can result in investor flight. This was precisely the chain of events that happened in the banking crisis of August 1998.[195] The volatile nature of rising inflation and the strengthening ruble are not the biggest problems relating to economic stability. William Tompson, senior economist at the Organization for Economic Co-operation & Development in Paris, argues that more serious problem is that natural resources generate large "rents," easy money that fuels corruption and state interference in the economy, as well as often sparking serious political strife among rival interest groups. Rents can have serious long-term effects on a country's social

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192 "Russia Country Analysis Brief," *Energy Information Administration*, Official Energy Statistics from the U.S. Government, (February 2005), accessed May 2005, http://www.eia.doe.gov/emeu/cabs/russia.html.

193 "Good in Part," *The Economist,* Library Surveys, (19 July 2001). Dutch disease, named after Holland's experience in the 1970s, when a strengthening currency made it impossible for local manufacturers to compete. The flood of petrodollars undermined manufacturing competitiveness by driving up inflation, as well as driving up the value of the currency and keeping it at an artificial high.

194 Peter Rutland, "Shifting Sands: Russia's economic development and its relations with the west," Sergei Medvedev, Alexander Konovalov, and Sergei Oznobishchev, eds., *Russia and the West at the Millennium* (George C. Marshall European Center for Security Studies, 2003), ch. 6, 119.

195 Ibid.

institutions and its political stability. Tompson calls the "resource curse" which "has more to do with politics than anything else."[196]

A second problem is that Russia's transition to a viable market economy is still hindered by significant amount of capital flight and questions surrounding property rights have not been answered.[197] In 2000, while Russia earned approximately $20 billion from the world markets on oil exports, roughly the same amount in capital left Russia.[198] According to Russia's central bank, net capital flight was more than four times higher in 2004 than the year before, at $9.4 billion.[199] A monthly poll conducted by the Association of Managers of Russia, in January 2005, revealed the following distribution of answers to the question of the reasons for capital outflow from Russia in 2004: 47% – poor protection of ownership rights, 38.6% – the YUKOS case, 14.5% – search for new investment objects, 1.2% – U.S. dollar fall, 1.2% – the summer 2004 banking crisis.[200] The poll reveals that Russians unwillingness to invest in their own economy stems primarily from the continued "uncertainty over property rights – a fear that capital investments will be seized by the state, or by other private actors operating through the corrupt legal system."[201] As illustrated in Figure 4 below, foreign investment in Russia almost equals domestic investment out of Russia.

196 Quoted in Jason Bush, "Russia: The curse of $50 per barrel," *Business Week,* 16 May 2005, posted in *Johnson's Russia List,* #9145, no.17.

197 Rutland, "Shifting Sands," 115.

198 David G. Victor and Nadejda M. Victor, "Axis of Oil?" *Foreign Affairs,* New York, (March/April 2003), vol., 82, iss., 2, 47.

199 "Crime and Punishment," *Economist Global Agenda,* 18 May 2005, posted in *Johnson's Russia List,* #9153, #15, 19 May 2005.

200 A. Radygin and Y. Simachev, "Russian Economy 2004: Trends and Outlooks," *Institute for the Economy in Transition,* Issue 26, (March 2005), 361, accessed May 2005, http://www.iet.ru/files/text/trends/2004eng/2004eng.pdf.

201 Rutland, "Shifting Sands," 115.

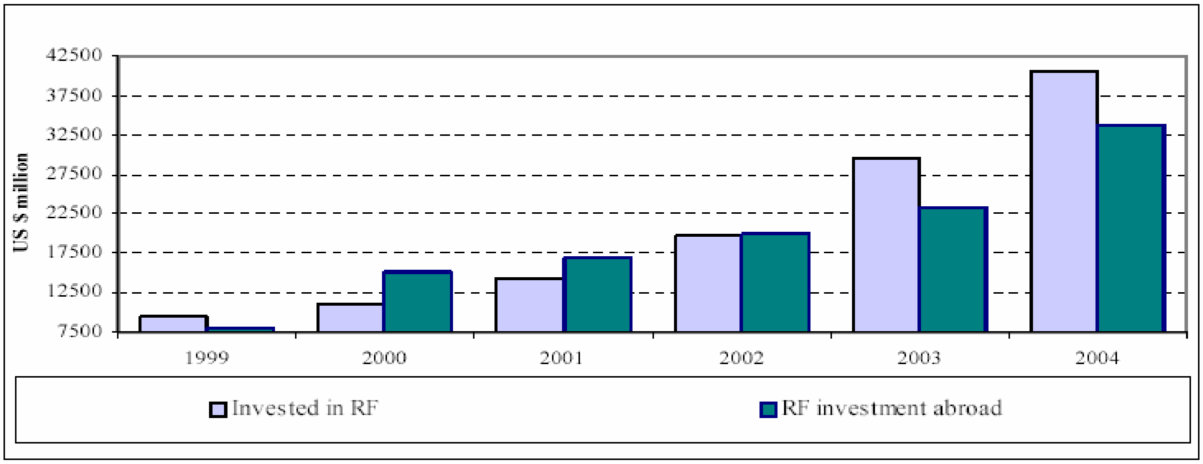

Figure 4. Foreign investment in Russia and Russia's investment abroad in 1999 through 2004 (From "Russian Economy: Trends and Perspectives," The Institute for the Economy in Transition, March 2005).

In 2003, foreign investment amounted to 18 percent of GDP; about half of what Russia needs to overhaul its 30 year old industrial infrastructure.[202] While Putin has paid lip service to attracting FDI, he has done little to pacify concerns surrounding property rights. These concerns were only amplified in the fall of 2003 when the Kremlin went after Yukos and jailed Khodorkovsky for tax evasion and fraud, leaving investors wondering if Putin was planning a wholesale revision of the privatization of the 1990s.[203] In July 2004, the government confiscated Yukos as payment for its huge tax bill, and subsequently sold it in December to little known BaikalFinansGroup (BFG) for $9.3 billion. BFG was then absorbed by state-owned Rosneft.[204] The sale of Yukos was criticized heavily by presidential economic advisor Andrei Illarionov as he called it "the swindle of the year."[205] Putin tried to reassure both Russian and Western businessmen through several meetings and radio addresses by saying:

> The main thing, and what we should not forget as we introduce these changes, is that the oil and the fuel and energy sectors are like the goose

[202] Rutland, "Russia in 2003," 26.

[203] Ibid., 27.

[204] Alex Nicholson, "Putin Defends Yukos Transfer," *Rocky Mountain News AP,* 24 December 2004, 5B.

[205] C.J. Chivers, "Putin Demotes Advisor Critical of the Kremlin," *The New York Times,* 4 January 2005.

that lays the golden eggs, and it would be stupid, unreasonable and unacceptable to kill the goose. But don't worry, this will not happen.[206]

Despite these reassurances, negative attitudes persisted from liberals and some senior government executives as they believed the Yukos transaction was in violation of ownership rights, created an unfavorable investment environment, collapsed confidence in the government, and effectively moved the government towards an autocratic regime.[207] Initially it appeared to investors that what happened to Yukos was no more than a political brawl between Khodorkovsky and the Kremlin; but when the justice ministry seized Yukos, some interpreted this as the government redistributing the property and putting the control of the oil industry into trusted hands.[208] The 'trusted hands' were those of Igor Sechin, who was appointed as chairman of Rosneft in July of 2004, and who would later position Rosneft to purchase Yukos in December.[209] The message from the Kremlin to investors appeared to be that what really matters is control over cash flow rather ownership and that for investment in the energy sector to move forward, interested companies will have to deal with the Kremlin directly.[210]

One thing remains clear, no matter how murky the water gets, Western oil companies are still willing to pursue deals in Russia. This is in part due to increased demand for oil from not only the United States but from China and Japan as well. It is also due to the fact Russia ranks second to Saudi Arabia when it comes to oil production and is considered a viable alternative to Middle Eastern oil. Examples of joint ventures in 2004 alone include: BP, which currently has the largest joint venture with TNK at $8 billion; Chevron Texaco looked to invest with Sibneft along with Total; Conoco Phillips is looking at expanding its relationship with Lukoil; and Royal Dutch/ Shell has the

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206 President Vladimir Putin, Excerpt from a Radio Address with the Population, Moscow Kremlin, March 18, 2003, http://www.kremlin.ru/eng/text/speeches/2003/12/18/1200_57480.shtml accessed February 2005.

207 A. Radygin and Y. Simachev, "Russian Economy 2004," 361.

208 Carola Hoyos, and Arkady Ostrovsky, "Politics First: the Kremlin tightens its control over the commanding heights of Russia's economy Moscow's targeting of Yukos, the country's biggest oil group, shows that power is shifting towards state-oriented companies such as Lukoil," *Financial Times,* The Financial Times Limited, London, England, August 5, 2004, Comment & Analysis, 15.

209 Carola Hoyos and Arkady Ostrovsky, "Politics First."

210 Ibid.

largest single direct investment in Russia's Sakhalin region.[211] Oil, however, is not the only place that investors are willing to put their money; Russia's antiquated phone system has been highlighted as a possible opportunity for growth and two of its wireless firms, Vimpel Communications and Mobile Telesystems, are being traded in the United States.[212]

While interest in the oil sector remains high, other sectors are lagging and new government actions can only serve to discourage investment. The government seems to be in an internal battle of how much foreign investment it is willing to allow. During 2003 and 2004, the government promoted new legislation that would weaken minority shareholder rights, launched an investigation into foreign investments into Gazprom, and has shrugged off entreaties from Washington to broaden its energy relationship with the United States, in light of the rise in oil prices and feared instability in the international economy.[213] Since the government seized Yukos, several non-energy sector deals have suffered: Alcoa Inc. and Siemens AG had plans to buy separate facilities in Russia. These have been held up by the government's anti-monopoly agency. Cargill Inc. has encountered problems reclassifying land for a Russia-based project; and Exxon Mobile had its license for a project on Sakhalin Island stripped away.[214] The government is keenly aware that these issues make investment in Russia less attractive and it is attempting to solve its problems with regards to weak institutions, poorly defined and enforced property rights, and violations of minority shareholders' rights. Yet until sufficient progress has been made towards solving its problems and becomes visible to potential investors, confidence will remain relatively low and investment risks will remain high in Russia.[215]

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211 Carola Hoyos and Arkady Ostrovsky, "Kremlin tightens its control over Russia's economy," *Financial Times UK,* (5 August 2004).

212 Murray Coleman, "Investors Still Bullish on Russia Despite Bear's Claws on Yukos: Money managers hope crackdown vs. oil giant will be an isolated case," *Investor's Business Daily,* August 10, 2004, Section A, National Edition, A01.

213 Peter Baker, "Russia's Uncertain Business Climate," *Financial Times*, washingtonpost.com, August 21, 2004.

214 Ibid.

215 Yevgeny Gavrilenkov and Wolfram Schrettl, "Integration into the World Economy: Russian Dilemmas," Sergei Medvedev, Alexander Konovalov, and Sergei Oznobishchev, eds., *Russia and the West at the Millennium* (George C. Marshall European Center for Security Studies, 2003), ch. 7, 133.

Putin has seen some success through continued growth in annual GDP. Since taking the reins in 2000, Russia has seen an average 6.5 percent growth in GDP from 2000-2003.[216] Most of which can be attributed to high oil prices. If Putin truly wants to strengthen Russia's economy he will need to commit to strengthening other economic sectors – especially transportation, information technology, telecommunications and agriculture – rather than relying solely on energy exports.

[216] Stuart D. Goldman, "Russia," CRC Issue Brief for Congress, updated January 5, 2005, CRS-7.

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V. CONCLUSION

> Russia should be and will be a country with a developed civil society and stable democracy. Russia will guarantee full human rights, civil liberties, and political freedom. Russia should be and will be a country with a competitive market economy, a country where property rights are reliably protected and where economic freedom makes it possible for people to work honestly and to earn without fear or restriction. Russia will be a strong country with modern, well equipped and mobile armed forces, with an army ready to defend Russia and its allies and the national interests of the country and of its citizens. All this will and should create worthy living conditions for people and will make it possible to be an equal in the society of the most developed states. And people can not only be proud of such a country – they will multiply its wealth, will remember and respect our great history. This is our strategic goal.[217]
>
> Vladimir Putin

The purpose of this thesis has been to explore trends of Russian economic reform specifically as they related to the direction that Putin is attempting to drive the Russian economy. The evaluation of these trends began with the Gorbachev era starting with *glasnost* and *perestroika,* as that is where the seeds of reform were planted. The Gorbachev era provided the baseline for understanding the need for reform to the Soviet system. It also showed that Gorbachev's reforms, though radical by Soviet standards, were not revolutionary. The reforms did, however, open the door for 'new thinkers' to push towards developing a market economy and democratization.

The Yeltsin era of the 1990s found Russia faced with essentially building a market economy from the ground up. This thesis argued that the reformers took a simplistic view of establishing a market economy, as they relied on several assumptions that would later prove to have a serious impact on the development of the economy. These assumptions included the belief that economic institutional reform would just 'happen' as a result of developing a market and that Russian investors would behave the same as their Western counterparts. Neither assumption proved to be true, as the lack of institutional infrastructure impacted everything from efficiency, to investment, to growth,

[217] Vladimir Putin, State-of-the-Nation Address, 16 May 2003, quoted in Richard Sakwa, *Putin: Russia's Choice,* (London: Routledge, 2004), 234.

to the rise of crime and corruption, and the social welfare of the country. On the investor side, Russian investors proved to be easily manipulated by claims of instant wealth and many suffered extreme financial losses. Some good did come out of the reform efforts. As Russia moved through its painful transition it was able to stabilize its currency and develop a balanced budget, as well as accomplish the mass privatization that moved Russia towards becoming a market economy. [218]

When Putin took office he was clear in his intention to keep Russia on the road of economic reform. He immediately worked to create fundamental institutions that were missing including civil, tax, budget, labor, land codes, and pension law. The government took strides in deregulation, improved interbudgetary relations, and progressed further towards accession to the WTO.[219] In the beginning, it appeared that Putin was attempting to create a 'managed democracy;' however, his actions revealed that he is moving the country towards 'managed capitalism.' He effectively launched an attack on corruption by regaining control of the state through suppression of the oligarchs' influence in political matters, the implementation of new tax reforms on businesses, and the strategic placement of those loyal to him in power positions of the government and the economy. His actions did have a negative impact on the economy, specifically when the government went after Khodorkovsky and Yukos in 2003, the result was a significant decrease in FDI and increase in capital flight. Although the energy sector has proven to be quite resilient and still able to attract FDI, Putin's actions still leave investors concerned and wary as to how much they trust that their interests will be protected.

A. A LOOK AHEAD

Over the last five years Russia has seen a steady growth in GDP, most of which can be attributed to oil production; tentative figures show that growth for 2004 was approximately 7.1 percent. For 2005, Russia should expect to see a realistic rise in GDP at a rate of 5.8-6.0 percent, even though the current budget is projecting a growth rate of

[218] S. Zhavoronkov and V. Norikov, "Russian Economy 2004: Trends and Outlooks," 13.

[219] Ibid.

6.3 percent.[220] The reason for the small discrepancy is due to the drop in oil prices over the past few months. Currently Russia's oil reserves rank eighth in the world and second behind Saudi Arabia in production.[221] As the demand for oil from the United States and China continues to increase, investors are looking to expand the Russian oil market as alternatives to Middle Eastern oil are explored. With Putin's restructuring and oil prices on the rise, Russia can expect to see continued growth in the future. Russia did receive some good news in February 2005, when Standard & Poor one of the most conservative rating agencies, gave Russia a "B–" with a "stable" forecast (with the proviso, however, that political decisions and actions of regulatory agencies are unpredictable), which provides for investments from long-term conservative investors.[222] However, Putin will need to invest in developing other economic avenues and market institutions in order for Russia to draw the capital into the country it so desperately needs to develop a stable and viable market economy.

As Putin moves into his second term he has put forth several tasks and goals that he would like to see accomplished, including the doubling of Russia's annual GDP by 2010. In his annual State of the Nation address he laid out the goals of a stable democracy and developed civil society, the strengthening of Russia's international positions, and the substantial growth in the well-being of Russia's citizens.[223] In addition to doubling GDP he also emphasized the following tasks of reducing poverty, improving people's prosperity, and restructuring the army.[224] Putin is relying primarily on high oil prices for Russia to reach its goal of doubling its GDP by 2010. He has also asked officials to reduce inflation from its current 10 percent to 3 percent, and also asked for more tax reform to help lure investors from Russia's competitors. In his address, Putin appears to reassure critics that there will not be another Yukos (although he did not

[220] "Economy ministry forecasts 6% GDP growth for 2005" *The Russian Journal Daily,* February 2, 2005, http://www.russiajournal.com/news/cnews-article.shtml?nd=47259, accessed on February 13, 2005.

[221] "Country Analysis Briefs Russia," accessed July 2004, http://www.eia.doe.gov/emeu.cabs/russia.html.

[222] A. Radygin and Y. Simachev, "Russian Economy 2004: Trends and Outlooks," 361.

[223] Vladimir Putin, "Annual Address to the Federal Assembly," *The Kremlin,* (April 25, 2005), accessed May 2005, http://www.kremlin.ru/eng/speeches/2005/04/25/2031_type70029_87086.shtml.

[224] Ibid.

mention it specifically) as he has asked the tax authorities to put a statue of limitations of three years for investigations into tax fraud. He also called for continued reform in the protection of property rights. While he did not mention establishing a credible rule of law, he did mention "rules to which the state adheres in this sphere should be clear to everyone, and, importantly, these rules should be stable."[225] It is interesting to note that with regards to FDI, Putin urged officials to draft a system of criteria to determine the limitations on foreign participation in specific sectors of the economy. Most of the limitations would be in the energy sector where it appears that Putin wants to maintain a direct influence. While Putin apparently intends to keep tight controls on investment within the energy sector he does want to "create favorable conditions for the inflow of private capital to all the other attractive sectors."[226] Finally and perhaps most importantly, Putin asks that Russians keep the flow of capital in Russia, by paying their 13 percent tax on income and depositing the rest in banks as "this money should work in our economy, in our country, not lie in offshore zones."[227]

Can the Kremlin 'have its cake and eat it too?' In a private meeting with Putin, Economic Minister German Gref reportedly told Putin that it could not, as sustained economic growth was being hindered by too much state intervention.[228] Over the past several weeks, since Putin gave his address and the reading of the Khodorkovsky verdict began, there has been a lot of speculation with regards to what Putin wants and the path that he is taking with the economy. Peter Lavelle argues that it is not hard to perceive Putin as "authoritarian." "In most ways he is. Given Russia's current development trajectory, Putin probably has to be."[229] Lavelle believes that Russia is at an extremely important juncture. Either the Kremlin continues its very hard-handed approach to restructuring and reforming the economy or it risks international concerns that Russia

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225 Vladimir Putin, "Annual Address to the Federal Assembly," *The Kremlin,* (April 25, 2005), accessed May 2005, http://www.kremlin.ru/eng/speeches/2005/04/25/2031_type70029_87086.shtml.

226 Ibid.

227 Ibid.

228 Peter Lavelle ed. "Experts on Putin's 'calculated retreat'," *Johnson's Russia List 9115,* no. 8, April 8, 2005.

229 Peter Lavelle, "What Does Putin Want?" *UPI*, Commentary, (July 29 2004), accessed May 2005, http://archives.econ.utah.edu/archives/a-list/2004w43/msg00031.htm.

will revert to an "Upper Volta with nuclear weapons."[230] In the past Putin has made it clear that he does not intend to turn back the clock. Putin's actions can be interpreted as 'necessary' to get a handle on Russia's rampant corruption and if he intends to accomplish the goals he set forth in his State of the Nation address.

There is constant debate in the media about how much the Yukos case has influenced investment in Russia. Some experts claim that it really has not had an effect, while others claim that the effect is seen in the rate of capital outflow out of the country. The United States is keeping a close eye on the Yukos case, not to gauge investment levels but to determine the state of the rule of law within Russia. Even the Duma sees the trial as a litmus test for where Russia stands with regards to the judiciary. Another organization that is monitoring the case is the WTO, as Russia hopes to someday become a member. The West in general, the United State in particular, has been consistently critical of how Russia has handled the Yukos case as a whole and continues to voice its concerns, especially when it appears that Putin is moving away from establishing a democracy with a transparent market economy. Many experts continue to question Putin's motives and actions. Some have even gone so far as to suggest that Putin will change the Russian constitution so that he may continue to serve as president. Most of this is all speculation and beyond the scope of this thesis. It can be concluded that Putin inherited a system in which he was constrained by the legacy of the past and he has taken the necessary actions to counter corruption and has kept Russia on the path of economic reform through 'managed capitalism.'

However, Putin could have done more. Some of the most basic economic institutions remain weak at best, the most significant deficiencies lie in the establishment of the rule of law which protects property rights. The judiciary is still under the influence of the Kremlin, despite words to the contrary. For example, the government continues to influence the proceedings of Khodorkovsky case; Khodorkovsky was held for almost a year before his trial got underway; and the media reported that the court was ordered from "higher up" to speed up the reading of the verdict.[231] Also, Putin's actions with

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[230] Peter Lavelle, "What Does Putin Want?"

[231] "Court accelerates reading of the Khodorkovsky Verdict," *Radio Free Europe/Radio Liberty,* RFE/RL newsline, vol., 9, no., 88, part 1, 24 May 2005.

regards to the Yukos case may be interpreted as politically motivated and undermines Russia's efforts at becoming a transparent market economy. The next few years will prove to be a turning point for Russia as it approaches the 2008 election. Will Russia make a successful transition in 2008? Can Russia maintain its current level of economic growth? Will Russia be able to recover from the effects of 'Dutch disease?' Only time can answer these questions.

B. THE YUKOS VERDICT

On May 16, 2005, Judge Irina Kolesnikova began reading the five inch thick, over 1,000 page verdict, which is more than simply a reading of guilt or acquittal but a long laborious reading of summations from the prosecution and defense as well as judiciary comments. On May 31, 2005 Khodorkovsky was convicted guilty on six of the seven counts of fraud and tax evasion, and was sentenced to nine years in prison.[232] Prosecutors had wanted the maximum of ten years per count.[233] The decision immediately sparked more speculation about investment climate and the state of the rule of law within Russia. Although a guilty verdict was expected, the verdict prompted President Bush to openly criticize the Russian judicial system by stating "that it seemed that Khodorkovsky had been adjudged guilty prior to having a fair trial."[234]

In an interview with Neil Buckley from the *Financial Times,* Anders Aslund spoke to what many experts believe to be true by stating "I don't think that Putin can afford another Yukos, but on the other hand, you could say that the bureaucracy is out of control."[235] An out of control bureaucracy is as equally dangerous to the Russian economy as is another Yukos case for establishing rule of law should it act for political

232 Christian Lowe and Dmitry Zhdannikov, "Russia's Khodorkovsky jailed for 9 years," posted in *Johnson's Russia List,* #9164, no. 9, 31 May 2005.

233 Nicholson.

234 Ariel Cohen, Ph.D., "The Khodorkovsky Verdict: A setback for U.S.-Russia relations," *The Heritage Foundation,* web memo #753, accessed June 2005, http://www.heritage.org/Research/RussiaandEurasia/wm753.cfm.

235 Neil Buckley, "Aftershocks will keep Foreign Investors on edge," *Financial Times,* 17 May 2005, posted in *Johnson's Russia List,* #9151, no. 16, 17 May 2005.

vice legal reasons. If the government continues to move against private enterprise for political reasons it will only undermine the efforts to develop the institutions necessary to protect property rights as well as develop a transparent market economy.

However, the question of "will there be another Yukos" remains. Recent moves against some companies would suggest yes. VimpelCom, the mobile phone operator, was hit with a $158m (Euros 120m, Pounds 83m) back-tax bill in December 2004. The tax authorities later quietly lowered this to $18m, apparently after high-level government intervention. In April 2005 TNK-BP, the oil joint venture that is Russia's biggest foreign investment, saw a back-tax demand for 2001 raised sevenfold to nearly $1bn.[236] These actions do not bode well to foster an investment friendly economic environment. Instead they only serve to keep investors guessing as to whether or not Putin is serious about creating a viable transparent market economy.

Putin apparently does believe in developing a market economy, just not in the sense that westerners have envisioned, but rather that of a state-controlled market economy. The dominant trends over the past four years, as argued by Alexander Radygin, an economist at the Institute for the Economy in Transition, "have been the growing expansion of property interests of the Russian state, an attempt to establish control over capital flows in the Russian economy, and a desire to make business dependent on state institutions."[237] Given the hurdles that Putin has had to leap in order to get a handle on corruption, it is not surprising that Putin has elected to move toward greater state control over the economy and the state itself. However, state-control does not resolve the fundamental problem of institutional development and reform. Putin has essentially paid lip service to the establishment and enforcement of institutions of transparency, accountability, and property rights. He has pushed for solid land and labor laws and tax and budget codes, but it is not enough. He needs to step up his efforts to develop those institutions that are still very weak, including strengthening the judiciary and those government agencies that ensure that the law is applied equally and effectively. Only then will Russia achieve its goal of developing a transparent market economy.

236 Buckley.

237 Carola Hoyos and Arkady Ostrovsky, "Kremlin tightens its control over Russia's economy," *Financial Times UK,* (5 August 2004).

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